
ASIAN MONETARY MONITOR

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January - February 1980

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EDITORS:

John G. Greenwood

M.A. (Hons) Econ. Edinburgh
Research Economist, University of Tokyo
Economist at G.T. Management (Asia) Ltd.

Christian Wignall

B.A. Econ. Cambridge
Economist at G.T. Management (Asia) Ltd.

Hugh Sloane

B.A. Econ. Bristol
M. Phil. Econ. Oxford
Economist at G.T. Management (Asia) Ltd.

**CHARTS AND
STATISTICS:**

S.Y. Chan

Michael Wong

ADMINISTRATION:

Isabella L.Y. Ling

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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

HONG KONG

THE TEMPORARY STRENGTH OF THE HONG KONG DOLLAR

There are few examples in history of economies which have grown at double-digit rates for four consecutive years. Japan managed it in the mid-1960s, Korea and Taiwan have also been among the high fliers. Hong Kong achieved double-digit growth figures in both 1962 and 1963, and in 1965 reached a phenomenal 18.3%. 1969 and 1973 were also good years, but all these periods have been outshone by the post-oil crisis years 1976-1979, during which Hong Kong's real GDP grew at an average rate of 12.7% per annum.

Refugees and the labour market

Without a doubt the present growth cycle has been sustained by a rapid influx of population which has enabled output to expand rapidly even after unemployment had fallen to negligible levels in 1978. Table 1 shows the key trends in the labour market over the past three years.

Table 1

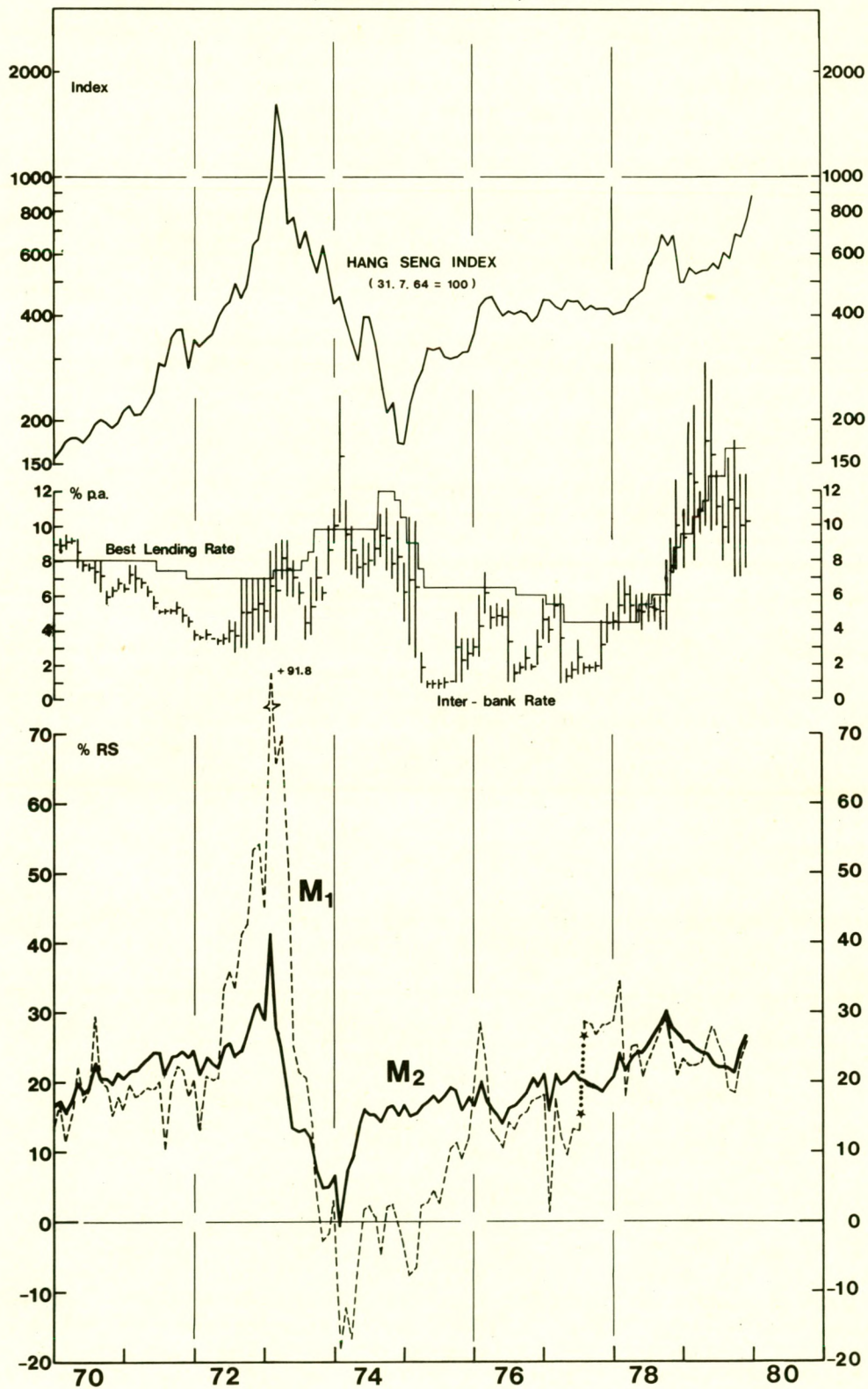
	Labour force % RS	Employment		Unemployment rate	Real Manufacturing Wage % RS
		Total % RS	Manufacturing % RS		
1977 Mar.	-1.0	0.2	8.2	4.5	5.6
Sept.	1.7	2.2	-2.6	4.1	4.5
1978 Mar.	3.8	5.4	1.3	3.0	6.1
Sept.	5.5	7.1	4.3	2.7	6.8
1979 Mar.	4.8	5.6	6.0	2.3	11.6
Sept.	6.6	5.8	11.2	3.4	3.2

(% RS: Percentage change since the same period of the previous year.)

Until 1978 the Hong Kong government had believed that an unemployment rate of about 4% represented virtually full employment, but to the amazement of many people the rate fell to 2.3% in March 1979 (equivalent to a mere 1.7% by the United States definition of unemployment). The extreme tightness in the labour market was reflected in the rapid acceleration of real wages which rose 11.6% in the manufacturing sector in the twelve months up to March, and the number of vacancies in the manufacturing sector alone (70,000) was more than the total number of people unemployed. It was likely that wage costs were biting into profits, since the real wage bill* in March had risen 17.8% on a year earlier compared with real GDP growth of probably only 11% or so.

- - - - -
* Real wages multiplied by total number employed.

HONG KONG
CHART 1: MONEY, INTEREST RATES, AND STOCK PRICES



* Change of data series

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However, between March and September 1979, two new factors affected the labour market; firstly an influx of immigrants helped to swell the labour force by 4.7%, and secondly the reduction in government construction work cut the demand for labour in the building industry. As a result the pressure on the labour market as a whole eased; the unemployment rate rose, the number of vacancies declined slightly and real wages fell 4.4%. The influx of workers was in fact so great that the labour market was able to satisfy a voracious 8% growth in the manufacturing sector's labour force during the second quarter. The total real wage bill showed almost no growth at all during the second and third quarters, since the increase in the numbers employed was offset by declining real wages, and the entire growth of private sector income in that period accrued to profits.

In business cycle terms it can therefore be argued that the influx of refugees has put the clock back two years. The evidence suggests that the share of profits in national income has been restored to the levels of early 1978 and the labour market has eased back to the level of unemployment and vacancies prevailing at that time. In many ways the boom in external demand and the influx of refugees have transformed the unstable, unbalanced economy of early 1979 into a much fitter animal for 1980, giving the current business cycle a new lease of life.

In addition unrestrained credit expansion and a floating currency have removed any financial constraint on expansion. As a result Hong Kong has not suffered the balance of payments crises and deflations which brought the economic booms in Korea and Taiwan to an end in 1979. On the contrary, and almost perversely, the trade balance has been improving, the currency has been firm and real GDP growth in 1979 was probably faster than in 1978.

Monetary Developments

Despite these encouraging developments all is not well with Hong Kong. Arguably there was some slowing of credit expansion early in 1979, but the money supply figures for the latter part of the year suggest that this trend has reversed; domestic loans and advances by the financial system (banks plus deposit-taking companies) grew 34% in 1979 and M_3 grew 30% in the same period. Since the official money supply statistics have been revised it is not possible to compare these figures with earlier years directly but some idea of the trend can be gleaned from the figures in Table 2.

As we predicted in earlier issues of AMM, raising interest rates has failed to arrest monetary growth, since the banks continue to have unrestrained access to reserve assets. Aside from the monetary statistics there is further evidence from the economy that credit has, if anything, eased. After falling at the beginning of 1979, property prices rebounded and prime land in the centre of Hong Kong was being auctioned for nearly double year-earlier prices in November. The stockmarket,

after many months of nervous trading, also rocketed during the summer and by the end of the year the index was 63% higher than at the beginning of May.

These are not the characteristics of an economy readjusting and deflating in response to a balance of payments constraint, but rather the signs of a continuing inflationary boom. Why then has the trade balance improved and the Hong Kong dollar strengthened?

Table 2

Annualized rate of growth over three months ending:

1979	M ₂ *	M ₃	Domestic loans and advances
March	19.8	22.7	33.5
**April	12.5	13.7	28.7
May	14.6	21.2	29.2
June	23.3	23.6	24.5
July	23.0	25.8	26.7
Aug.	29.9	25.2	24.0
Sept.	27.0	28.3	29.6
Oct.	28.8	34.7	26.1
Nov.	35.4	37.7	34.4
Dec.	-	45.5	49.7

* M₂ by the old definition i.e. including DTC's deposits at commercial banks. M₂ grew 25.6% during 1978 and 20.7% during 1977.

** Distorted partly by the seasonal effect of Chinese New Year celebrations. Examination of M₂ data for earlier years suggests that there is virtually no other significant seasonal factor and that data for the other months give a fair representation of the underlying trend.

The External Sector

The improving balance of payments in fact owes more to the inflationary boom overseas than to any abatement of inflation in Hong Kong.

Chart 2 shows the growth rate of the aggregate GNP and money supplies of four major economies expressed in US dollar terms. These aggregates are useful proxies for world aggregate demand for imports and indicate that the upturn in 'world demand' which began in 1977 had, by the beginning of 1979, reached the proportions of the 1973 boom and implied a rapidly growing demand for Hong Kong exports. As can be seen from this chart and from Chart 3 Hong Kong consequently enjoyed an export boom (in nominal terms) in 1979 comparable with those in 1973 and 1976. The rate of growth of exports overtook the rate of growth of imports in spring of 1979 and continued to outpace imports throughout the year even though imports showed no sign of slowing down.

This strength in the export sector has been reflected in movements in the labour force back into manufacturing and away from services and construction. To repeat, this is not a sign of an economic slowdown but merely the competitive reallocation of resources to the external sector within the context of a high overall level of demand and a rapidly expanding labour force. The 'improvement' in the balance between the external sector and the domestic sector has come about not because inflationary pressures in Hong Kong have eased but because inflation overseas has caught up.

Table 3 illustrates the close relationship between Hong Kong's export performance and the demand for imports by Industrial Countries:

Table 3

Year-to-year percentage changes.

		US dollars	US dollars		
		Value of Imports	HK Domestic Exports		
		of Industrial Countries	Value	Volume	Price (c)
1977	I	19.4	14.1	-1.1	15.2
	II	16.7	12.2	4.7	7.5
	III	11.4	12.8	6.2	6.6
	IV	7.9	8.7	7.9	0.8
1978	I	11.1	6.2	3.4	2.8
	II	13.5	15.4	10.1	5.3
	III	16.3	15.1	11.6	3.5
	IV	24.4	22.0	14.9	7.1
1979	I	21.9	23.9	16.2	7.7
	II	23.6	24.6	16.2	8.4
	III	34.2 (a)	34.0	20.1	13.9
	IV	-	31.0	17.1(b)	13.9

(a) Average of July and August figures.

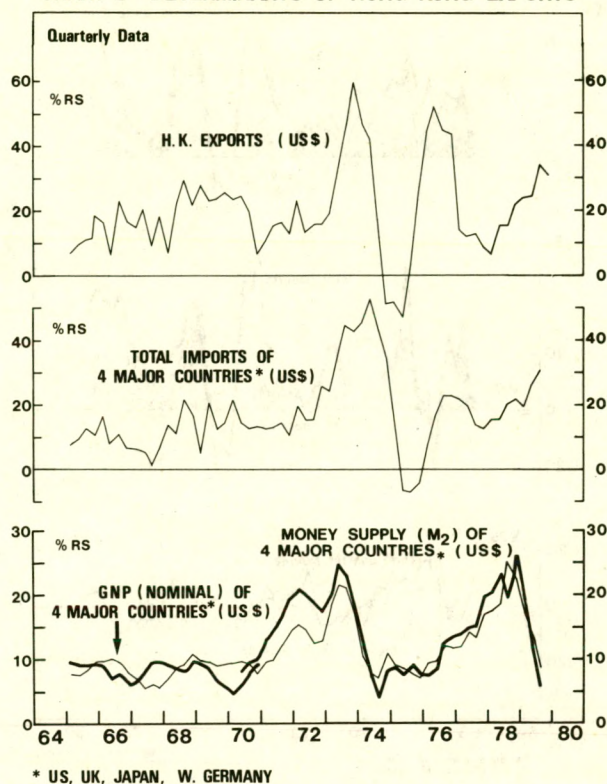
(b) Average of October and November figures.

(c) Price change equals Value change minus volume change.

Source: IMF for value of Industrial countries' imports.
'Hong Kong Monthly Digest of Statistics' for Hong Kong exports.

The table shows clearly the extent to which Hong Kong's trade performance has gained from the recovery in world activity during the past two years. Although the figures show a virtually continuous acceleration in the growth of Hong Kong domestic exports since the beginning of 1978, in fact the faster growth in export earnings during 1979 depended mainly on inflation. The volume of exports was growing at about 16% year-on-year at the end of 1978 and was still growing at the same rate twelve months later, but export prices (in US dollars) accelerated from about 7% to 14% p.a. An examination of the GNP statistics for Hong Kong's major trading partners shows a similar picture: inflation accelerated but real output growth stabilized during the year.

HONG KONG
CHART 2 : DETERMINANTS OF HONG KONG EXPORTS



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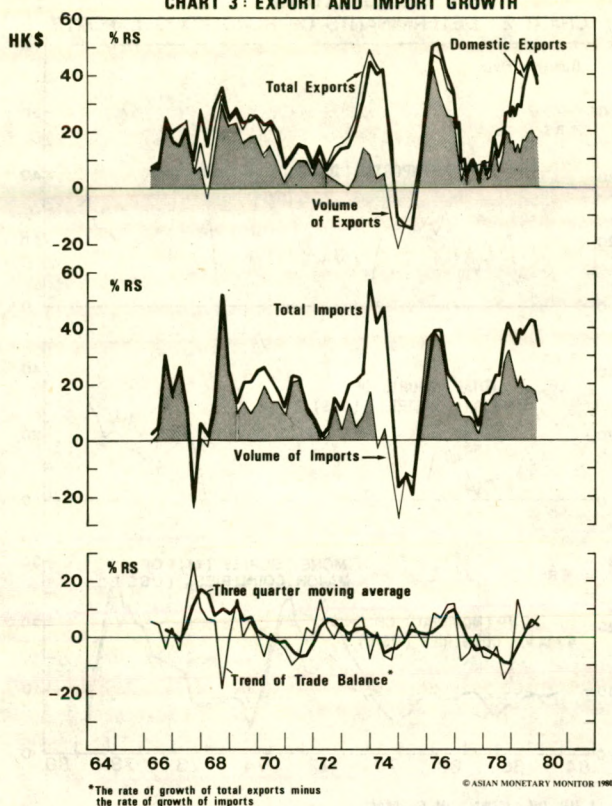
The Exchange Rate

The outlook for the Hong Kong dollar in 1980 depends primarily on whether external demand for Hong Kong's exports keeps pace with the continuing domestic inflation. If it does not, the Hong Kong dollar will come under pressure again. A purchasing power parity analysis (see Chart 5) suggests that Hong Kong exports remain highly competitive and there is little danger of Hong Kong losing market share. There is however a real threat of declining aggregate demand in overseas markets and some indicators show a softening in the volume of exports and export orders towards the end of 1979. It would certainly be unusual if the current inflation were not followed by a correction in world markets in due course.

Since most countries have been following progressively tighter monetary policies since the beginning of 1979 it can only be a matter of time before this translates into weaker aggregate demand. Chart 2 shows that the total money supplies of four major countries slowed down very sharply in US dollar terms during 1979, just as the same indicator did in 1973. However the implications for Hong Kong exports are not nearly as drastic as in the earlier period since a portion (but not all) of the slowdown can be ascribed to the collapse of the yen against the dollar (and therefore of the Japanese monetary aggregates measured in dollar terms) which, while significant for world trade in general, is relatively unimportant for Hong Kong since Japan represents less than 9% of total Hong Kong exports.

HONG KONG

CHART 3: EXPORT AND IMPORT GROWTH

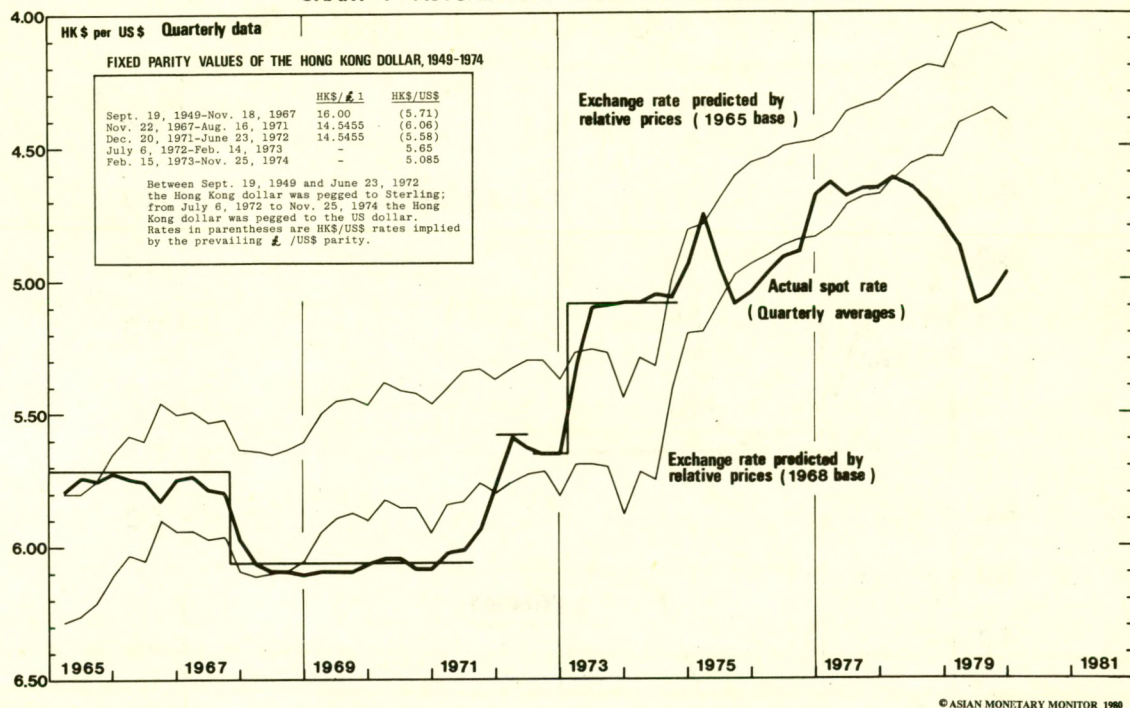


Nevertheless it is likely that Hong Kong domestic export growth will slow down during 1980, falling to a year-on-year rate of 15% or less in the second half, and in volume terms falling to lower than 3% or so. With credit expansion still very high in the colony it is unlikely that import demand can slow sufficiently to prevent a deterioration in the trade balance and renewed weakness in the currency. With the balance of payments position deteriorating interest rates in Hong Kong will not fall and may even rise. Inflation will also remain high and rising and economic growth will continue to exceed the government's forecasts.

If monetary forces cannot be relied upon to terminate the economic boom and overall economic activity continues to be resilient in the face of weak external demand (as was clearly demonstrated in 1977), what then could check the growth of the Hong Kong economy?

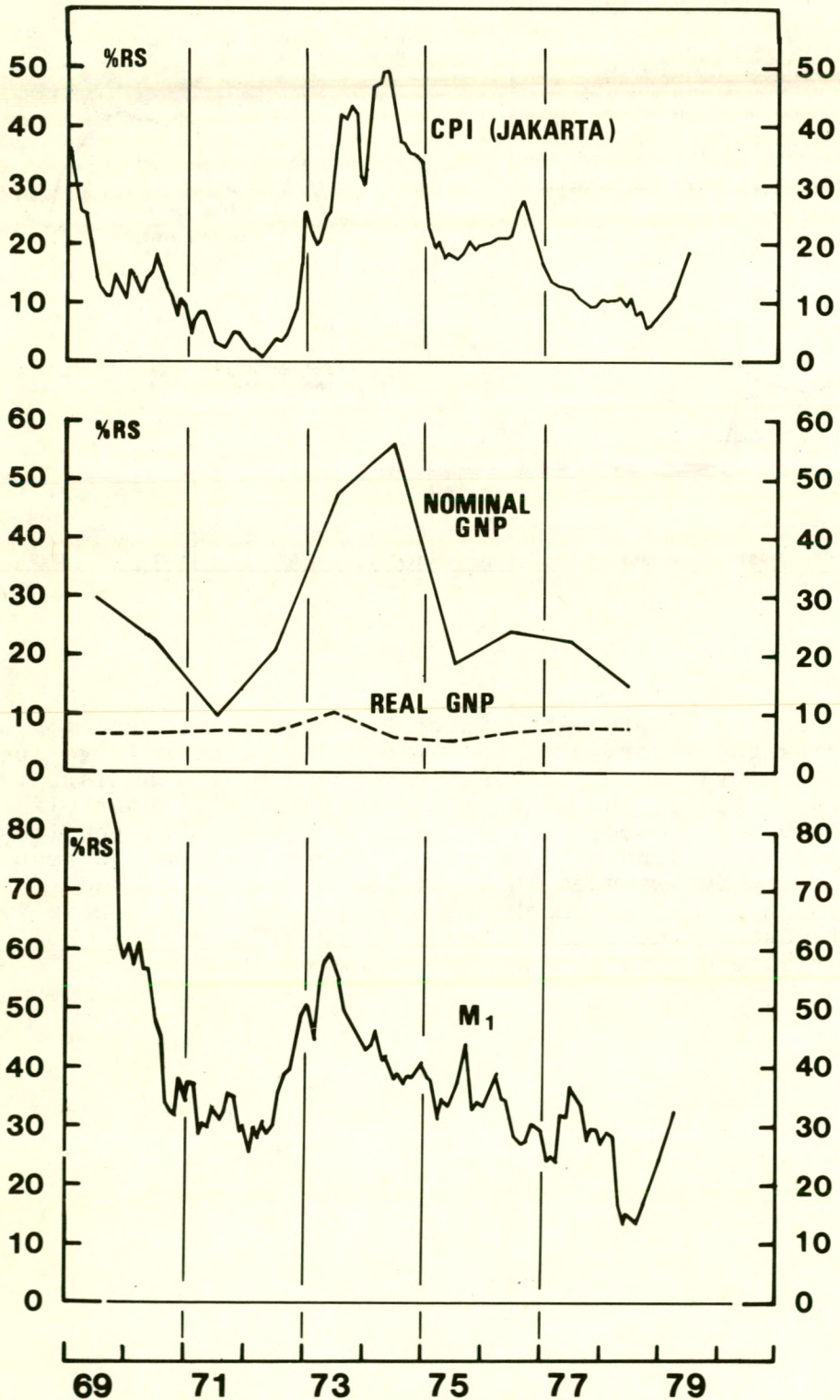
The primary threat to growth comes not from a shortage of labour (often important in the final stages of a business cycle when wage costs eat into profits) which has been alleviated by the expansion of the labour force, but from inflation. An inflationary environment engenders instability in financial markets, increases the risks for long term investment plans and encourages speculative hoarding and over-investment in property. In a nutshell, inflation interferes with the price mechanism, making it progressively more difficult for efficient investment decisions to be made, and in due course this impairs the prosperity of the economy. In the shorter run inflation

HONG KONG
CHART 4 : ACTUAL AND PREDICTED EXCHANGE RATES



can do damage by provoking inept government intervention aimed at curing the symptoms of inflation. The sudden large increase in interest rates in 1978 was one such move which disrupted activity briefly, the blanket extension of rent controls in late 1979 was another. Silly official threats to the financial sector to curb lending indicate another area where bureaucratic control may be extended in the future. Unanticipated government-contrived shocks to the system such as these are the biggest threat to confidence in 1980; an overall collapse in aggregate demand is much less likely.

CHART 1: INDONESIA **MONEY, OUTPUT AND PRICES**



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INDONESIA

THE AFTERMATH OF DEVALUATION

The profile of the Indonesian business cycle since the last oil crisis of 1973-74 is quite different from those of other S.E. Asian economies, notably the Philippines and Thailand, which in other respects are economies comparable with Indonesia. For almost the whole period 1973-78 monetary growth in Indonesia was decelerating, whereas in the Philippines, Thailand and other fixed exchange rate economies of the Far East there was first a sharp monetary slowdown in 1974-75, followed by a vigorous upturn from around 1976. Thus instead of enjoying a boom in the late 1970s as most Asian economies did, Indonesia was suffering from stunted growth, business confidence was at a low ebb, and the only apparent benefit was that the inflation rate had dropped from over 40% per annum in the 1973-74 period initially to around 20% in 1975-76 and finally to below 10% in late 1978. (See Chart 1.)

Despite this achievement on the inflation front, official dissatisfaction with the country's performance in economic growth was one of the basic reasons for the precipitous 33% devaluation of the Rupiah on November 15, 1978. Having taken such a drastic step the authorities would, in the normal course of events, have had to wait a considerable time for any evidence of the success of the devaluation, simply because large structural changes take a considerable time to work themselves out. However, Indonesia was fortunately rescued by the series of oil price hikes following the Iranian revolution in 1979. As Indonesia is one of the few significant oil-producing nations in the S.E. Asian region, these changes in the price of her leading export combined with the favourable impact of the devaluation on other sectors have produced a dramatic improvement in Indonesia's external balance of payments just at a time when the Philippines, Thailand, Korea and Taiwan have all been getting into external difficulties. Thus once again the Indonesian economy, for all its similarities with other developing economies in Asia, is again experiencing a quite different set of economic circumstances from those of its less fortunate neighbours at this stage in the cycle.

How is it that Indonesia has apparently been able to deviate so far from the standard business cycle pattern which we have described for other countries in AMM? There are two broad reasons. One is that Indonesia's foreign trade structure is so radically different from that of her S.E. Asian neighbours that large movements in the country's terms of trade and foreign exchange earnings have occurred, and these could account for most of the difference. A second is that because the Indonesian government rather than the private sector is the direct beneficiary of the increased oil revenues, the authorities have had the discretion to peg the exchange rate for long periods at levels which may have been far from appropriate from the standpoint of other industrial and agricultural sectors.

Indonesia has long been an exporter of oil, but it is only in the 1970s that oil has come to play such an overwhelmingly important role in the country's foreign trade. As the table below shows, in 1974-76 exports of crude oil and petroleum products accounted for over 70% of the value of total exports. Rubber, which used to account for one fifth of the country's export earnings in the late 1960s, has seen its share decline steadily to around 5 or 6% of total exports. Lumber exports have varied substantially in terms of market share from year to year, but in recent years they have not recovered the prominence which they enjoyed in 1971-73.

TABLE 1

Percentage Composition of Indonesian Exports

	Crude Petroleum and Products	Rubber	Timber	Others
1969	44.8%	21.1%	3.0%	31.1%
70	40.3	19.3	9.1	31.3
71	45.8	16.2	12.8	25.2
72	51.4	10.6	12.7	25.3
73	50.1	12.2	17.7	20.0
74	70.2	6.4	9.6	10.8
75	74.8	5.1	7.0	13.1
76	70.2	6.2	9.1	14.5
77	67.2	5.4	8.8	11.4
78	63.9	6.1	8.5	21.5

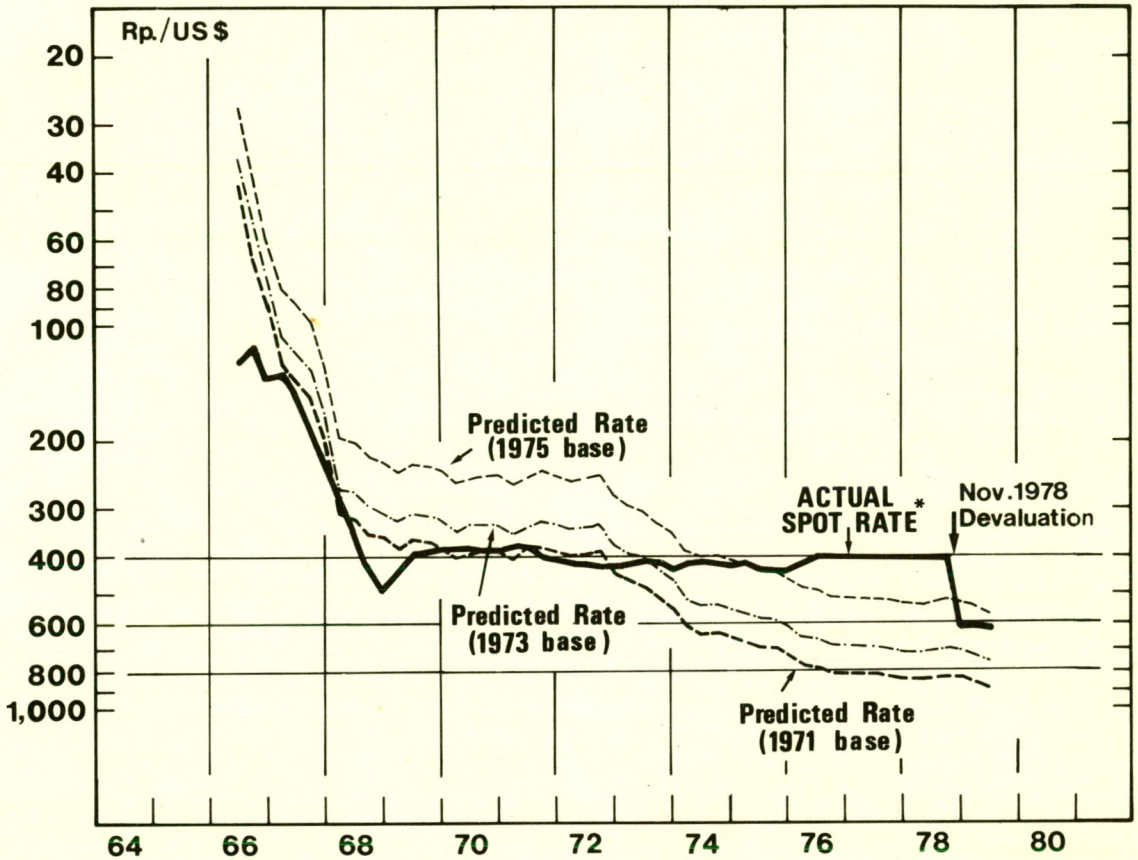
Source: IMF

Since there are no satisfactory indices of export prices and import prices it is not possible to make any accurate statement about the trends in the overall terms of trade, but a few broad observations can be made. The commodity boom of 1972-73 led first to an improvement in the terms of trade and a stronger balance of payments position. This was true for Indonesia as well as for other commodity exporters in the region. When towards the end of the commodity boom other countries in S.E. Asia began to experience a deterioration in their external balance around 1974, Indonesia was rescued by its membership of OPEC. The secondary boost to foreign exchange earnings from the oil price hike meant that the balance of payments was stronger than it otherwise would have been, and the domestic economy did not therefore have to go through such a tight monetary squeeze as, for example, Malaysia. The period 1975-76 was therefore characterised by significantly higher rates of inflation in Indonesia than in her competing neighbour economies. Instead of forcing adjustments on the domestic economy the change in the international price structure in effect enabled the authorities to postpone the adjustment process.

One way to look at Indonesia's position vis-a-vis foreign countries is to compare the level of internal prices with price levels elsewhere, adjusting for changes in the exchange rate

INDONESIA

CHART 2: ACTUAL AND PREDICTED EXCHANGE RATES



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Between 1967 and 1971 there was a series of changes in the official exchange rate as Indonesia moved from a multiple pegged exchange rate structure to a unified foreign exchange rate and as the external rate was adjusted downwards against the US\$ following the domestic hyperinflation of the mid-1960s. Because the official rates were often very unrealistic, the spot rate shown in the chart is the black or free market rate for U.S. dollars up to 1976 (from Pick's Currency Yearbook). After this the gap between the free market rate and the official rate narrowed, so the official market rates are used. The spot rates shown in the chart were also used in the calculation of the predicted rates.

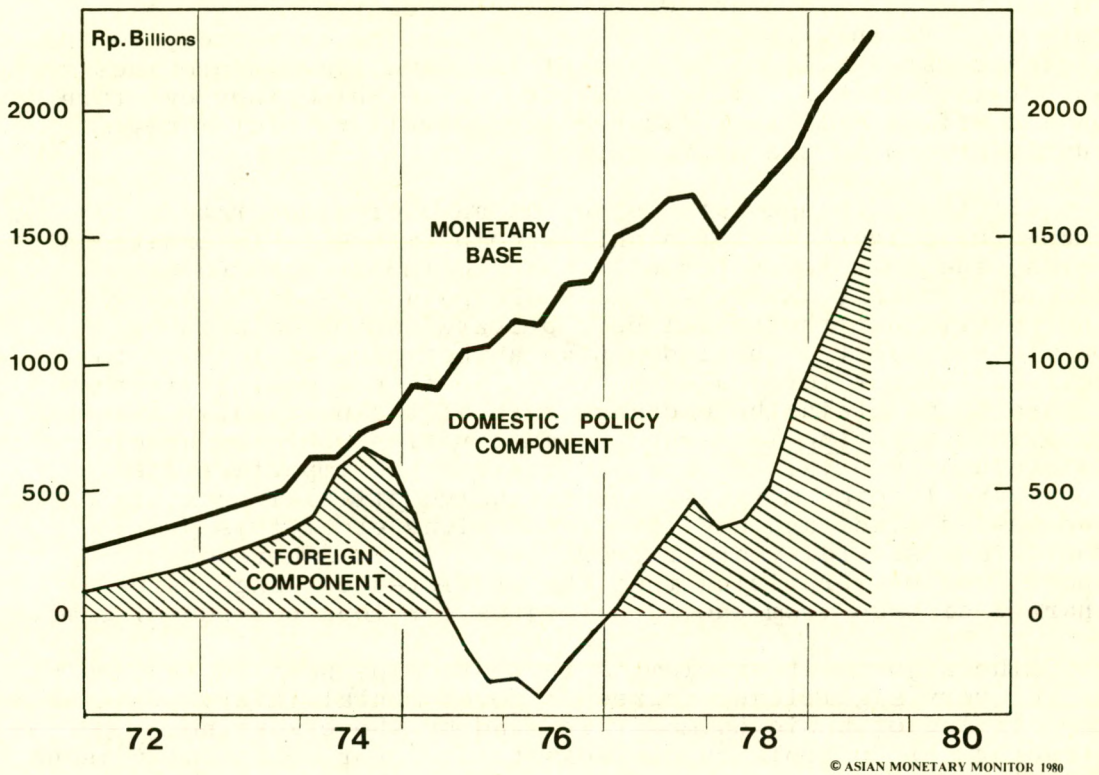
between the Rupiah and the foreign currency concerned. If this exercise is carried out using American prices and the Rupiah/US\$ exchange rate, it is clear that Indonesian products were - on average - becoming increasingly less competitive from about 1972 onwards. In Chart 2 it is assumed that the overall price levels of the two countries and the exchange rate were "in equilibrium" at three different base dates. If the exchange rate was correctly valued at each of these dates, then different relative price movements prior to and subsequent to those dates would require a different exchange rate to bring them into line again. It must be acknowledged that the validity of these types of comparisons is always suspect, especially so in the case of two countries at such different stages of development as the US and Indonesia, and particularly given the wide difference in the quality and coverage of the price indices used. The predicted exchange rates are therefore highly tentative and no significance can be attached to any level at one moment in time. However, the general direction of the predicted rates is probably helpful as a guide to the longer term strength of the currency.

If the exchange rate was correctly valued in 1971 at Rp. 415 per U.S. dollar following the official devaluation in August of that year, Chart 2 suggests that by 1979 the 'equilibrium' rate had fallen to almost Rp. 900 due to the difference in relative inflation rates between Indonesia and the U.S. In that event the authorities have succeeded in maintaining the actual rate far above the equilibrium rate for over 6 years. Alternatively, at the other extreme if one assumes the exchange rate was in equilibrium in 1975, then its current rate of Rp. 625 is near to the appropriate rate, but this means that throughout the period 1968-73 the currency was greatly undervalued. If this were true there ought to have been large balance of payments surpluses, something which did not occur until 1972-74. It would seem therefore that the first alternative is more likely to be correct - i.e. that since the big increase in oil revenues in 1973-74 the authorities were able to maintain the currency at an overvalued rate. How is this possible and how long can the present lower rate of Rp. 625 be maintained?

The strengthening of the country's external position in 1972-74 was reflected in the central bank's balance sheet which showed a substantial increase in net foreign assets (see Chart 3). Net foreign assets as a percentage of the monetary liabilities (or base) of the Bank Indonesia increased to 92% in late 1974. This highly favourable development was for a time interrupted by the Pertamina debacle, during which the Bank Indonesia on behalf of the government had to take over the huge foreign debts of the national oil company. The episode (described in AMM Vol. 3 No. 1, pp. 15-16) caused a marked shift in the components of the monetary base, but because the authorities continued to make credit available from domestic sources, there was no significant impact on the money supply held by the public. Having repaid Pertamina's debts the country's net foreign assets began to rise again in 1977. In the past year (1979) the net foreign asset position has

INDONESIA

CHART 3: SOURCES OF THE MONETARY BASE



substantially improved and we estimate that figures for the yearend will show that the position enjoyed by late 1974 will once again have been attained. In other words, in contrast to other Asian economies where the balance of payments is having a generally contractionary impact on monetary growth, in Indonesia the authorities' main problem is to prevent the huge expansion in foreign earnings from having an unduly expansionary influence on the base and hence on the money supply.

If Indonesian oil revenues accrued entirely to private individuals in Indonesia there can be little doubt that these earnings would be converted into local currency and used to finance expenditure either on investment goods (capital equipment and inventory) or on consumption. In other words they would become part of the domestic money supply and would subsequently fuel additional expenditures. The overall inflationary impact would then depend mainly on the rate of monetary creation relative to the increase in the output of domestic goods and services. However, the rate of monetary creation derived from the oil revenues would in turn depend on the exchange rate: the higher the rate, the less the Rupiah earnings per barrel of oil, and conversely. This process is short-circuited under current arrangements in Indonesia because the authorities acquire the bulk of the oil revenues directly, and it is within their discretion as to how much needs to be converted from foreign currency to domestic currency. As long as the authorities have substantial accumulated reserves overseas they can shore up the exchange rate by a policy of

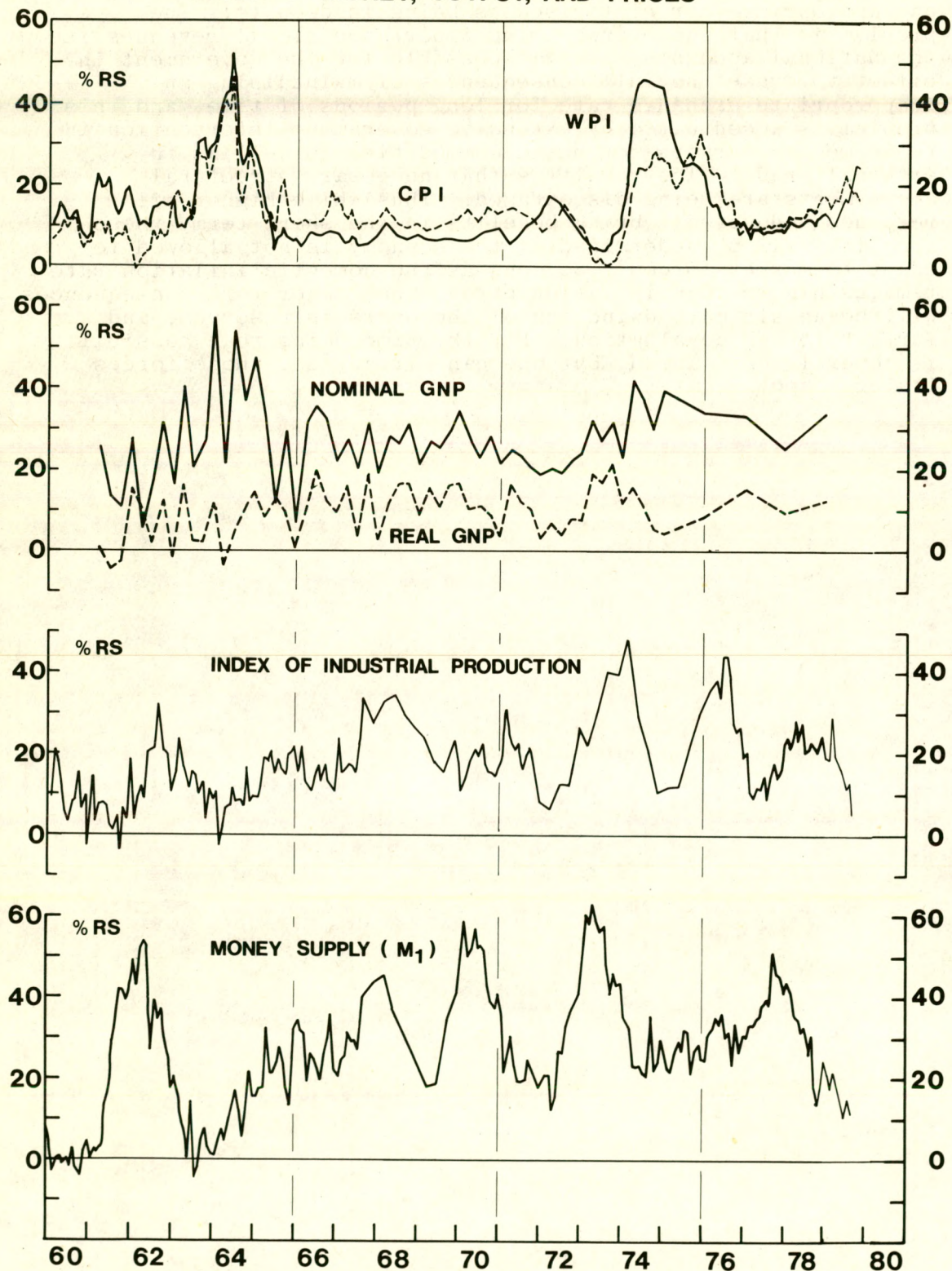
gradual repatriation designed to offset any downward pressure on the Rupiah. In other words official control of the oil revenues prevents the money supply adjusting as rapidly to the exchange rate as it might, and at the same time it provides the authorities with a fairly effective valve which they can turn on and off at will to influence the overall rate of money supply growth in the short term.

If the exchange rate is set at an overvalued rate which makes the private sector highly uncompetitive in international terms, the private sector will tend to import more (because foreign currency is artificially cheap) and export less, with the result that there will be a private sector balance of payments deficit. The Indonesian authorities would have to sell sufficient foreign exchange to meet that deficit if they wished to maintain the exchange rate at the particular fixed rate. Thus in the long run the authorities would be unable to maintain an overvalued rate, but, given the imperfections in local and foreign markets, the extensive official controls on Indonesian trade and capital transactions etc., this process could take several years to work itself out. Therefore it should not be surprising that the predicted exchange rates in Chart 2 diverge from the actual rates for long periods of time.

The adjustment problem is further compounded in Indonesia by the very significant degree of governmental intervention in the pricing of basic commodities, and by the byzantine structure of controls on overseas trade. For political reasons the government was already committed to controlling the prices of 9 basic commodities including rice, sugar, maize and cooking oil (a derivative of coconut) - all essential components of the average Indonesian household's daily expenditure - and following the November 1978 devaluation these controls were extended to over 200 other items. By keeping prices pegged at artificially low levels the authorities are purchasing a temporary political advantage at the cost of frustrating the long run structural adjustment process. A similar mechanism is at work in the external sector. Instead of allowing the devaluation to provide the full incentives of higher selling prices to exporters the authorities were so concerned about the possible inflationary effects of devaluation that they imposed export quotas on 20 products such as copra, coconut oil (although it is no longer exported), palm oil products, livestock, and a range of basic foodstuffs in order to keep down domestic supply prices. Additional restrictions were also introduced in the markets for coffee, pepper, rubber, and timber all of which were aimed at stabilising local prices or ensuring 'fairer' distribution. The other edge of this sword of course is that holding down prices discourages production so that these potentially exportable goods may never actually materialise, and the export diversification that was supposed to be achieved by the devaluation is impeded.

FORECAST: Depending on the base date chosen, the 33% Indonesia devaluation of November 1978 can either be defended as suitable and appropriate, or criticised as being inadequate. The problem is that the overwhelming importance of oil revenues in the national accounts makes it possible for the government in effect to evade the full consequences of maintaining an inappropriate exchange rate for long periods of time, and this problem is accentuated by extensive government intervention in the domestic markets for basic commodities as well as in external trade. The result is that necessary structural adjustments are being discouraged. Thus while higher oil revenues undoubtedly bring benefits in the short term, these benefits will be undermined if the economy is not allowed to adapt to market forces. So long as the domestic inflation rate remains higher than inflation abroad the longer term consequences will be an ultimate dwindling of the overseas reserves, and a further forced devaluation. For the time being that possibility is several years ahead, but one can already see those forces taking shape.

SOUTH KOREA
CHART 1: MONEY, OUTPUT, AND PRICES



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SOUTH KOREA

ALLEVIATING THE PRESSURE

In the November-December 1979 issue of AMM we outlined the fundamental policy choice facing economies such as South Korea which fix the external value of their domestic currency in terms of a foreign currency. In order to maintain the relative price of domestic and foreign goods they can either adjust domestic price inflation and keep the exchange rate constant, or they can alter the exchange rate and allow inflation to continue as before. Both policies are geared towards maintaining international competitiveness and both are triggered by rapid changes in the balance of payments position of the economy in question. If an economy maintains its exchange rate at a fixed level its inflation rate automatically adjusts to prevent the price of its traded goods from becoming too uncompetitive. Because this adjustment does not occur instantaneously, the economy must undergo cyclical adjustments. If a country acts to maintain the competitiveness of its traded goods by altering the external value of its currency it may in principle reduce the fluctuations in industrial production that are implied by following a pegged exchange rate, because a revaluation or devaluation effectively enables such a country to follow a more independent monetary policy.

In South Korea's case the policy choice appeared to be reasonably straightforward. The authorities could have continued with the monetary squeeze which was the inevitable result of Korea's inflation rate being high in relation to that of the US, and which had already led to a cyclical fall in industrial production and economic growth. (See Chart 1.) Alternatively they could have devalued the won against the US dollar in an effort to revive flagging growth rates and a weak balance of payments position at the expense of permitting a higher level of domestic inflation.

In our last article on Korea we wrongly anticipated that the Korean authorities would choose the former option i.e. persist with the squeeze. In retrospect the authorities evidently decided that the cost of persisting with the squeeze was too painful. Rather than persevering with all the internal adjustments associated with reducing inflation and restoring external competitiveness indirectly, they preferred to take a shortcut: on January 12th they devalued the won by 16.55%.

Chart 2 is effectively a test of purchasing power parity theory applied to the Korean case: If Korean export prices change at a different rate to the price of US products, but the exchange rate remains constant, there will be a change in the direction and composition of trade between the two economies. If in the initial position the exchange rate was at its "equilibrium" level, a change in the relative price of Korean and US goods will lead to a "disequilibrium", as manifested by rapid changes in Korea's balance of payments. The question is then: What exchange rate would be required in order to realign

the price of US and Korean goods so that balance of payments "equilibrium" is restored? The problem is now one of choosing a base date which is characterised by a broad "equilibrium" between US and Korean export prices. As suggested above, a sensible criterion for choosing a base date would be one where Korea's balance of payments remained stable. However, rather than trying to be too rigid in our choice of a single base date we have chosen three base periods in order to gain a better overall view of the trend in the relative price of Korean goods, and the won/US\$ exchange rates they imply.

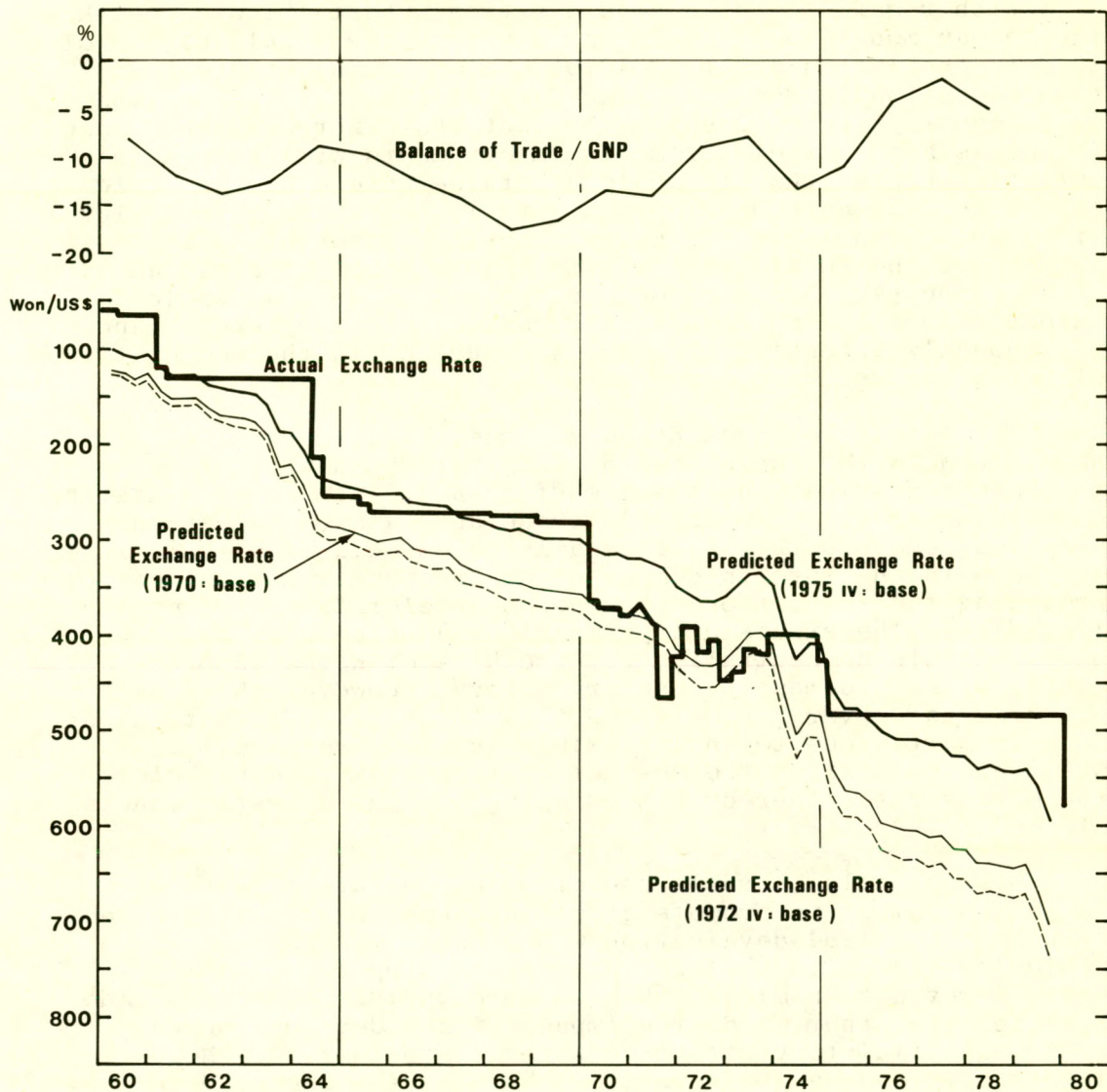
The actual exchange rate is shown by the thick solid line. Whenever the actual exchange rate is below the predicted lower limit (the exchange rate predicted from using the fourth quarter of 1972 as a base period) it implies either that US prices are too high, or Korean prices are too low, or the won/\$ exchange rate should be adjusted through a revaluation of the won. This has only happened on two occasions since 1960 and the won was revalued each time, firstly in 1971 and again in 1973. Conversely whenever the actual exchange rate rises above its upper limit then, we should expect the won to be devalued. The negative slope of the predicted exchange rate lines in Chart 2 indicate that Korean export prices have risen faster than their foreign produced substitutes. If the Korean authorities had decided to maintain their existing exchange rate the price of Korean goods would have had to have been sharply reduced relative to their US counterparts in order to maintain external "equilibrium". Assuming US wholesale prices increase by 12% during 1980, then for Korean producers to regain the level of competitiveness they enjoyed in the third quarter of 1975 (the last period their existing exchange rate had been within its "equilibrium" range) by the end of 1980, we estimate that Korean wholesale prices would have had to have fallen in absolute terms by 8.5%. Since Korean wholesale prices are currently rising in excess of 20% per annum an attempt to regain competitiveness in this way would have necessitated further large reductions in the rate of expansion in the money supply and in economic growth. This was plainly unacceptable to the Korean authorities.

Following the 16.55% devaluation of the won to 580 won per US dollar, there are now two major questions regarding the behaviour of the Korean economy over the coming year: First, will the devaluation be large enough in the context of a worldwide recession in 1980 to restore competitiveness and to stimulate a further period of export-led growth? Second, can the Korean prevent the benefits of devaluation from being whittled away by higher inflation?

A glance Chart 2 shows that the recent devaluation will almost certainly not be adequate to restore the competitiveness of Korean exports. Following the devaluation the won/US dollar rate remains above the upper bound of our constructed "equilibrium" range. Unless Korean inflation is very rapidly curtailed or there is a surge in US prices, Korea is still likely to be faced with a balance of payments deficit during 1980. On our estimates, the equilibrium exchange rate is

SOUTH KOREA

CHART 2: ACTUAL AND PREDICTED EXCHANGE RATES



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currently likely to be in the region of 650 won to the US dollar.

With regard to the second question, Chart 1 indicates that the Korean money supply fell rapidly from the final quarter of 1977 to the last quarter of 1979. We would anticipate that this reduction in domestic liquidity will have a lagged impact on consumer prices. Despite the fact that increased wholesale prices as a result of a rise in import costs will keep Korean inflation higher than it would otherwise have been, we would expect the Korean economy broadly to maintain its current level of competitiveness in the near future. However since the purpose of the devaluation was to enable Korea to avoid an even tighter monetary contraction, in the medium term we would expect to see an increase in the rate of monetary growth and consequently a tendency towards a reduction in the competitiveness of Korean goods.

The extent to which Korea's competitiveness will be undermined in the longer run depends partly on whether or not the recent devaluation is successful in its aim of facilitating export-led growth. If Korea's trade and balance of payments position recovers this will usually be associated with an increase in the foreign component of the monetary base thereby providing the foundation for renewed acceleration in domestic liquidity. The expansionary impact of a balance of payments surplus could be neutralised if the Bank of Korea adopted a contractionary domestic monetary policy. However the Bank of Korea has never accomplished this to any significant extent. This is partly due to an inflexible interest rate policy which has maintained the cost of central bank lending below the market rate, thereby discouraging a tight domestic monetary stance.

Historically, Korea's use of exchange rate adjustments as an instrument to promote growth has had surprisingly mixed results. The 1964 devaluation was broadly successful in achieving its policy objectives. As the upper panel of Chart 2 reveals, nominal GNP grew more rapidly than the trade balance. In other words the impact of the devaluation had a strong stimulatory effect on Korea's growth rate. More importantly, as may be seen from Chart 1, the increase in the money supply, following the devaluation, had a larger influence on industrial production than on consumer prices with Korean industrial output more than doubling during the 1964-1968 period whilst the inflation rate remained approximately the same. In contrast, the 1970 and 1971 devaluations were relatively less successful. Nominal incomes grew less rapidly than the balance of trade and although their overall increase initially reflected a rise in output this was subsequently reversed as a result of excessive monetary growth increasing consumer prices. Similarly the comparative advantage derived from the 1975 adjustment was gradually eradicated as a consequence of overly expansive monetary growth.

With the exception of 1977, the Korean government has devalued its currency on every occasion that industrial production has reached a cyclical trough during the past two

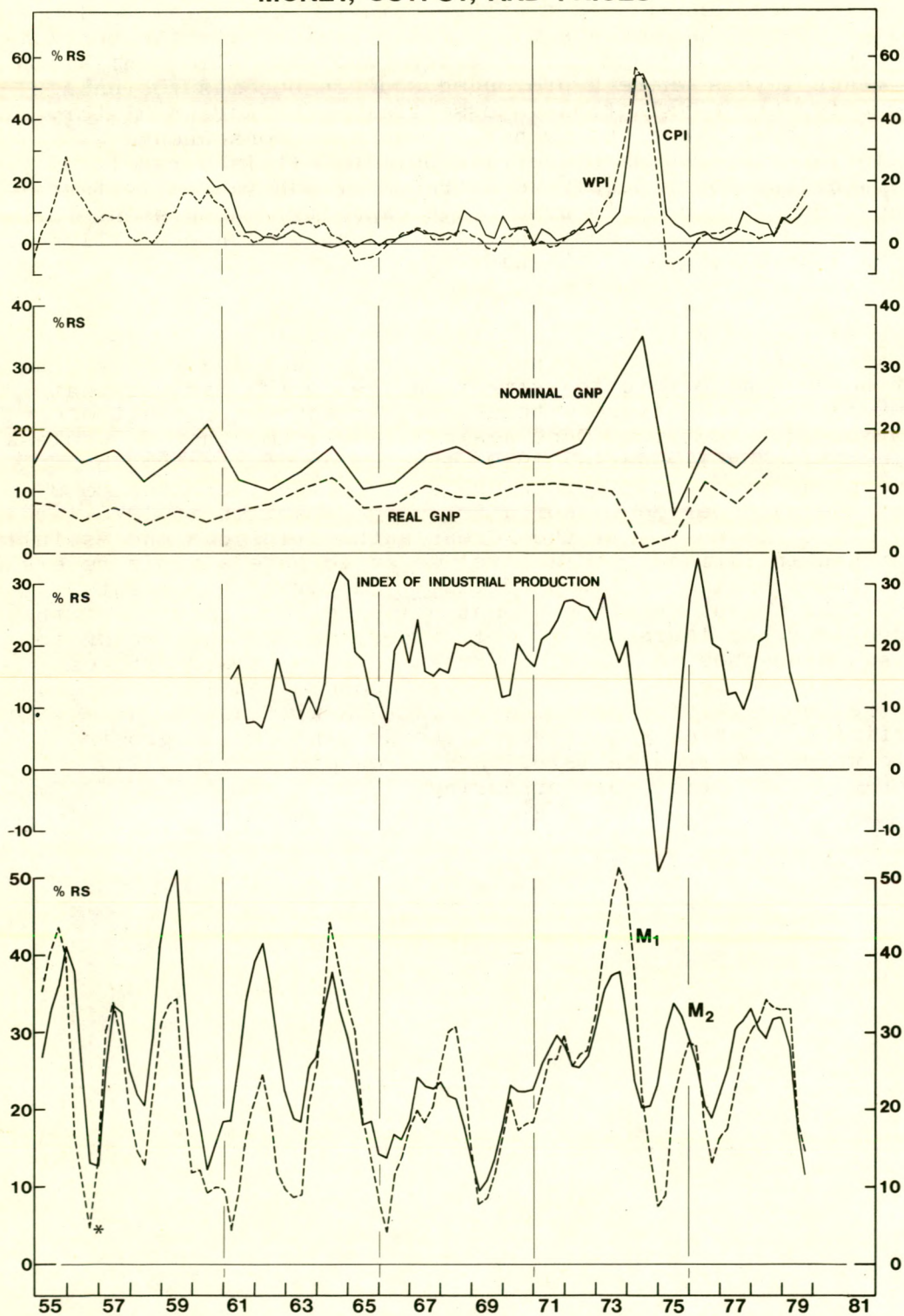
decades. In this way they have sustained impressive growth rates at the cost of high inflation because they have chosen to avoid the full impact of the cyclical downturns which rising export prices and a pegged exchange inevitably entail. Thus on past evidence the Koreans will probably dissipate the benefits of devaluation through higher prices and will allow inflation to reach levels where a prolonged squeeze becomes too painful and a further devaluation is essential. The Korean history of successive devaluations is not a necessary consequence of following a pegged exchange rate policy. It is a result of allowing the money supply to increase at substantially faster pace than the economy's productive capacity. At present there is no evidence to suggest that the Korean government will not repeat the mistakes of the past.

FORECAST: By failing to institute a sufficiently large devaluation the Korean authorities are signalling either that a further exchange rate adjustment may be forthcoming or that they intend to continue with a monetary squeeze, albeit one of reduced intensity. Once again if we assume that US wholesale prices rise by 12% during 1980, then on our estimates the government must limit Korean wholesale price increases to 9% over the same period if Korea is to re-establish its 1975 level of competitiveness. If the Korean authorities can successfully restrain inflation to this level we anticipate a rapid reversal in Korea's balance of trade deficit. However, two points should be noted. First, on past evidence, and in view of the recent further increases in oil prices, we have no reason to be sanguine about either the Korean government's desire or capability to restrict inflation. Second, even if Korea can secure competitively priced exports this will not occur sufficiently quickly to reverse the decline in its growth rate which occurred in 1979. Real economic growth will probably fall still further during 1980.

TAIWAN

CHART 1

MONEY, OUTPUT, AND PRICES



* Change of data series.

% RS — Percentage Rate of change over Same period of preceding year.

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TAIWAN

SLOWER GROWTH

As recently as October, Taiwan's Economic Minister, K.S. Chung, claimed that despite a deterioration in the balance of trade position his country's goal of an 8.5% real growth rate in 1979 was still attainable. Although data for the whole year is still unavailable it is almost certain that he will be disappointed. The Taiwan economy suffered a severe monetary and industrial slowdown last year and it is unlikely that its real growth rate exceeded 8%. This represents a dramatic decline from the record 12.8% real increase in Gross National Product that occurred during 1978.

As in the case of South Korea, this decline in Taiwan's overall increase in output should not have been wholly unexpected. By the beginning of 1979 both M_1 and M_2 had been expanding by more than 30% (on a year-on-year basis) for seven consecutive quarters. In our last article on Taiwan in the January-February 1979 issue of AMM, we argued that given the real GNP increase in 1978, an appropriate (i.e. non-inflationary) rate of annual growth in M_2 would have been in the region of 22%. The inflationary pressures generated by an excessive increase in liquidity could only have been mitigated during 1979 had the Taiwan economy continued to expand its real economic growth rate. However the increase in Taiwan's Wholesale Price Index during the last three quarters in 1978, up from 2% in April to 8% by the end of the year, slowed any further increases in output which would have acted to restrain further increases in price inflation.

The effects of this increase in domestic price levels on Taiwan's industrial production were accentuated by two other important factors. The price of Taiwan's exports to the US and Japan, which together account for more than half of Taiwan's export market, increased significantly during 1979 as a consequence of the yen's depreciation against the US dollar and the Taiwan government's decision to peg its currency at the new rate of NT\$36 = US\$1 (a 5.26% revaluation) in July 1978. Although the value of Taiwan's exports in 1979 were some 24% higher than in 1978, this represented a fall in export growth as compared with 1978, and there was little change in their volume. We may attribute this relative reduction in foreign demand for Taiwan's products to their increase in price. The second factor has been the 90% increase in the price of oil. Whilst this increase is not necessarily inflationary it effectively represents a transfer of real income from oil importing economies such as Taiwan to the oil producing nations. This inhibits the increase in real GNP which would be necessary in Taiwan to ameliorate the inflationary consequences of the rapid expansion in liquidity that occurred during 1977 and 1978. Furthermore, non-oil imports also increased rapidly in the last quarter of 1978 and in 1979 as the rise in real incomes created an increased demand for foreign products.

The net result of these influences has been a dramatic turnaround in the balance of trade and balance of payments position which has contributed to an impressive fall in the index of industrial production, as indicated in Chart 1. Taiwan's trade account in the first three quarters of 1979 showed only a surplus of US\$118 million as compared with a surplus of US\$1.3 billion in the same period in 1978. The balance of payments position indicates an even swifter reversal with a US\$2 billion surplus in 1978 being transformed into a US\$250 million deficit in the first half of 1979. The index of industrial production increased by a mere 7.5% in the first nine months of 1979 compared with 25% in the same period during 1978.* The failure to maintain the rapid increases in output that characterised the last quarter of 1977 and the whole of 1978 has inevitably, given the lagged impact of the surge in M_1 and M_2 in those years, led to increased inflation. The rise in the consumer price index has accelerated since October 1978 (see Chart 1) with the September 1979 quarter recording an annualised increase of 14% and wholesale prices rising 17½% on the same basis.

In arguing that the deterioration in the Taiwanese balance of payments position has contributed to, rather than been the major determinant of the slowdown in economic activity, we are in fact pinpointing a notable difference in the current cycle as compared with most previous ones. The orthodox adjustment mechanism in a pegged exchange rate economy such as Taiwan is primarily a monetary one: As the economy accumulates a balance of payments surplus there is a corresponding increase in the foreign component of the monetary base as the commercial banks convert net foreign exchange remittances into domestic currency at the central bank. This increase in the foreign component of the monetary base provides the foundation for an increase in the domestic money supply unless the central bank acts to offset this by reducing the monetary base's domestic component. If the central bank does not do so**then an increase in the money supply generally presages a rise in nominal income as a result of increases in output and inflation. The increase in nominal incomes raises the demand for imports and reduces foreign demand for exports (by increasing their overseas price as a consequence of a fixed exchange rate) thereby reducing the balance of payments surplus. As the economy moves into an external deficit there is a commensurate reduction in the rate of growth of the foreign component in the monetary base leading to a reduction in the growth of liquidity, a falling rate of growth in nominal incomes and so forth.

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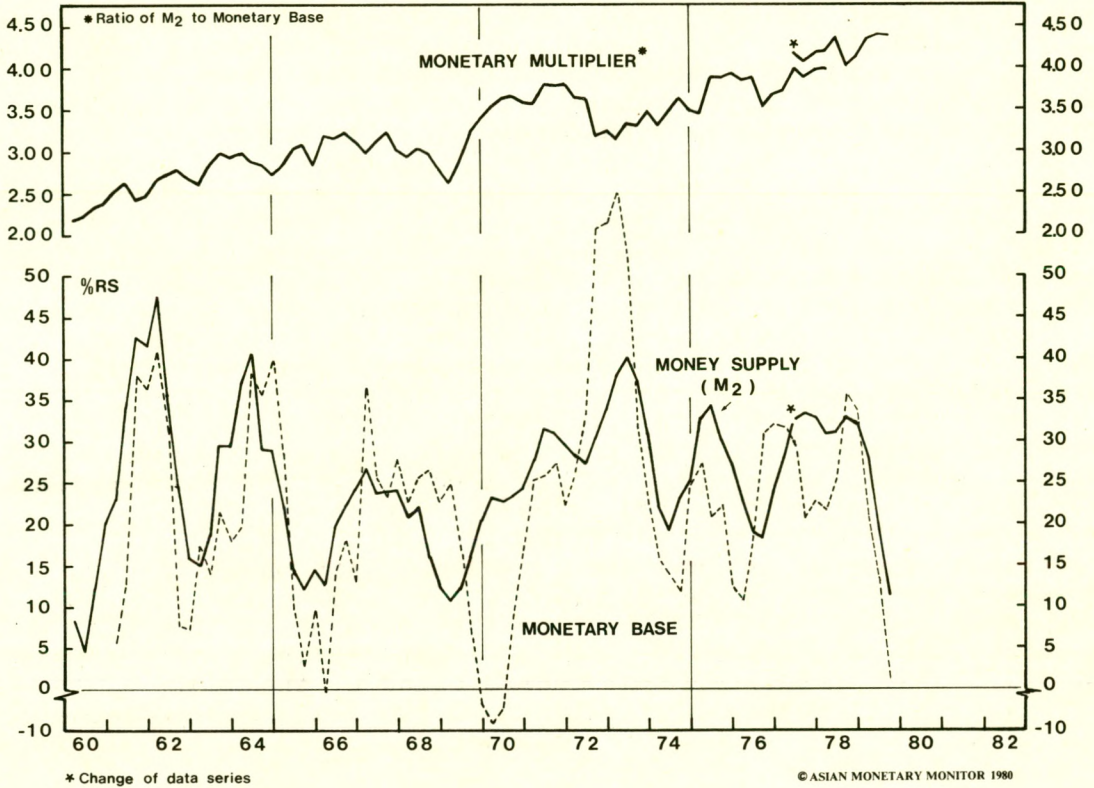
* Industrial production actually fell slightly in September 1979. This was the first monthly reduction in industrial output since July 1977.

** However it should be noted that the central bank can at best hasten or temporarily delay the impact of the automatic adjustment mechanism under a pegged exchange rate regime. A central bank cannot maintain an expansionary monetary policy for long before it encounters the exchange rate constraint.

TAIWAN

CHART 2

THE MONETARY BASE, MONEY SUPPLY AND THE MONETARY MULTIPLIER



TAIWAN

CHART 3: COMPONENTS OF MONETARY MULTIPLIER

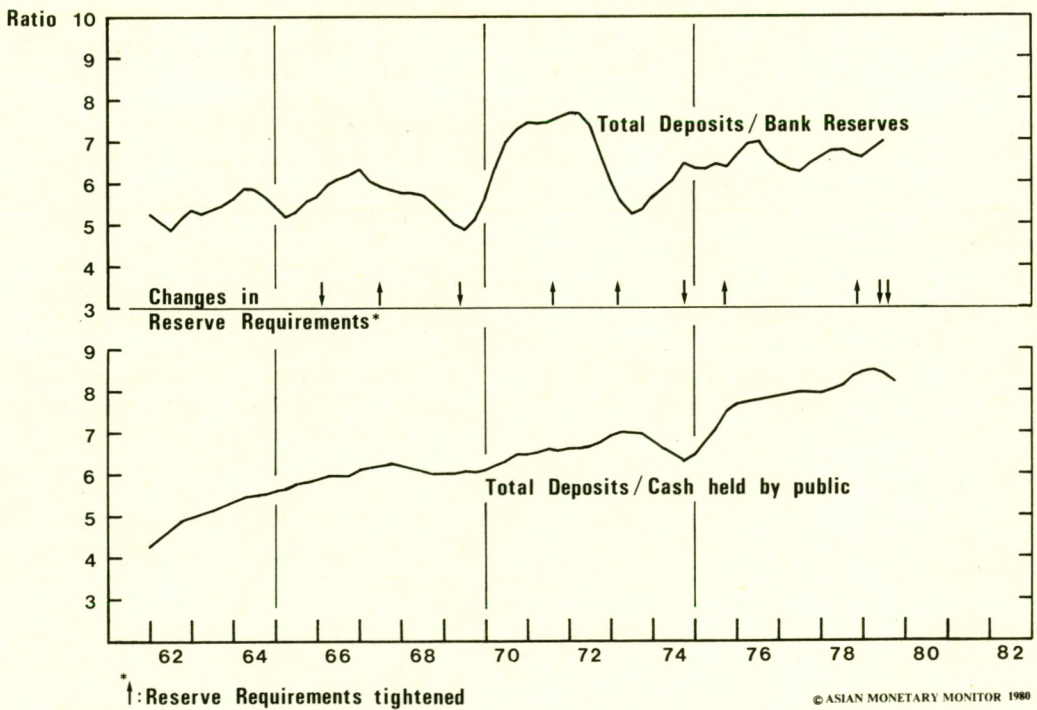


Chart 2 shows the relationship between the monetary base and M_2 in Taiwan since 1960. It generally supports the view that changes in the rate of growth of the monetary base are associated with changes in the rate of growth of the money supply. The only notable exception occurred in the 1969-70 period when a rapid contraction in the monetary base was offset by a 35% increase in the monetary multiplier as a consequence of changes in commercial banks' reserve requirements.

Chart 4 indicates that, generally, increases in the rate of growth of the monetary base are linked to increases in the growth rate of its foreign component except where the Central Bank of China has followed an offsetting monetary policy as in 1961 and 1969-1970.* However, the important characteristic of the current business cycle has been the stagnant growth rate of the foreign component of the monetary base. For reasons that are not clear the large increases in Taiwan's balance of payments surplus during 1977 and 1978 did not produce a rapid rise in the Central Bank of China's foreign asset holdings. Rather, changes in Taiwan's external position over this period were predominantly reflected in changes in the net foreign asset position of the commercial banks and thus did not contribute towards an increase in the monetary base. As may be seen from Charts 4 and 6, despite the large external surpluses on 1977 and 1978 the foreign component of the monetary base has actually shown a slight decline since the end of 1977. As may be seen from Charts 5 and 6, the whole of the increase in the monetary base in these two years was in fact due to a rise in its domestic component.

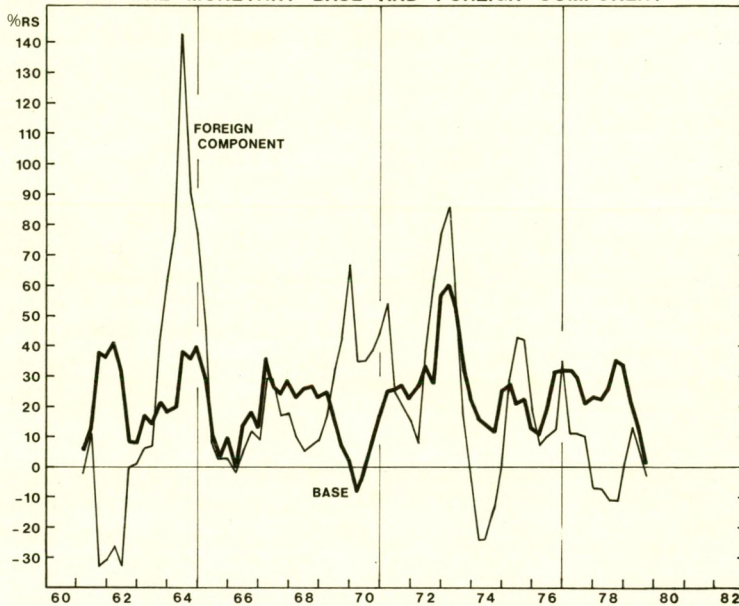
Consequently the behaviour of Taiwan's economy during the initial phase of the current cycle cannot be well described in terms of the orthodox adjustment mechanism outlined above, since there it was hypothesised that increases in the money supply were due to increases in the foreign source of high powered money. Similarly, the decline in the rate of growth of the monetary base during 1979 was initially due to a fall in its domestic source (i.e. The Central Bank of China's net credit to the commercial banks plus its net claim on the government) rather than a fall in its foreign component as a result of the deterioration in the balance of payments. It is for this reason that we have argued that the swing to an

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* The Central Bank of China's policy during the 1969-70 period appears to have been inconsistent. Following two years of erratic, but high, rates of inflation (see Chart 1) the Bank of China sought to counteract a 60% increase in the foreign component of the monetary base by a rapid reduction in its loans to the commercial banks. However at the same time the Central Bank of China also lowered commercial bank's reserve requirements by 20%.

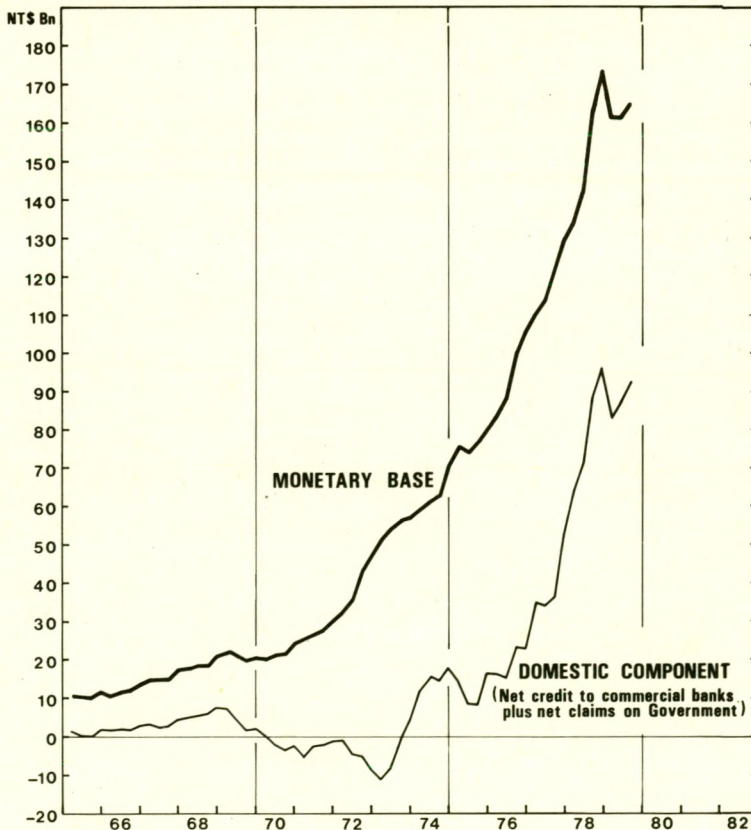
It is also of interest to note that the fall in consumer and wholesale prices during 1971 is one of the few occasions where such a decline has not been preceded by falling year-on-year growth rates in the monetary aggregates.

TAIWAN
CHART 4
THE MONETARY BASE AND FOREIGN COMPONENT



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TAIWAN
CHART 5
THE MONETARY BASE AND DOMESTIC COMPONENT



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external deficit has contributed to, rather than initiated, the fall in industrial production in 1979.*

In our last article on Taiwan we cautioned that the revaluation of the domestic currency provided no guarantee that excessive monetary growth would be curbed. In view of the fact that the recent increase in domestic liquidity appears to have been due to domestic monetary policy rather than the external position, the decision to revalue the N.T.\$ would appear to have been an inappropriate policy measure. Moreover it may prove to be destabilising - acting to amplify the swings in the business cycle rather than reducing them - if the external deficit it has encouraged does have an impact on the growth rate of the monetary base. The fact that the foreign source of the monetary base has shown an absolute decline (see Charts 4 and 6) in the second and third quarters of 1979 is consistent with such an occurrence.

The Central Bank of China's domestic monetary strategy was similarly erratic during 1979. Having sharply contracted its loans to commercial banks during the first quarter it then reversed its deflationary stance in May by reducing commercial banks' reserve requirements against checking and passbook deposits, and increasing credit to the commercial banks. In August, as if to highlight the ambiguity of its policy objectives, the Central Bank of China further reduced required reserve ratios by between twelve and eighteen percent, whilst in the same month increasing its rediscount rates by between one and a half and two percentage points. The effects of Taiwan's internal monetary policy on the monetary base and its domestic component are illustrated in Chart 5. The chart reveals, contrary to what might have been anticipated, that the fall in liquidity growth in Taiwan over the past six quarters is almost entirely due to a domestic contraction.

It is interesting to compare the monetary experience of Taiwan and South Korea during the present business cycle. Both economies are currently undergoing a monetary squeeze (although the growth of the money supply in Taiwan started to decline a year after it did in South Korea), and each has been experiencing sharply deteriorating balance of trade and payments positions. In both cases this was preceded by two years of rising real economic growth rates and a gradual acceleration in inflation. However in contrast to their similar economic backgrounds and comparable industrial structures, Taiwan and South Korea have exhibited very different responses to the problems posed by the cyclical behaviour of their economies: The Taiwanese authorities

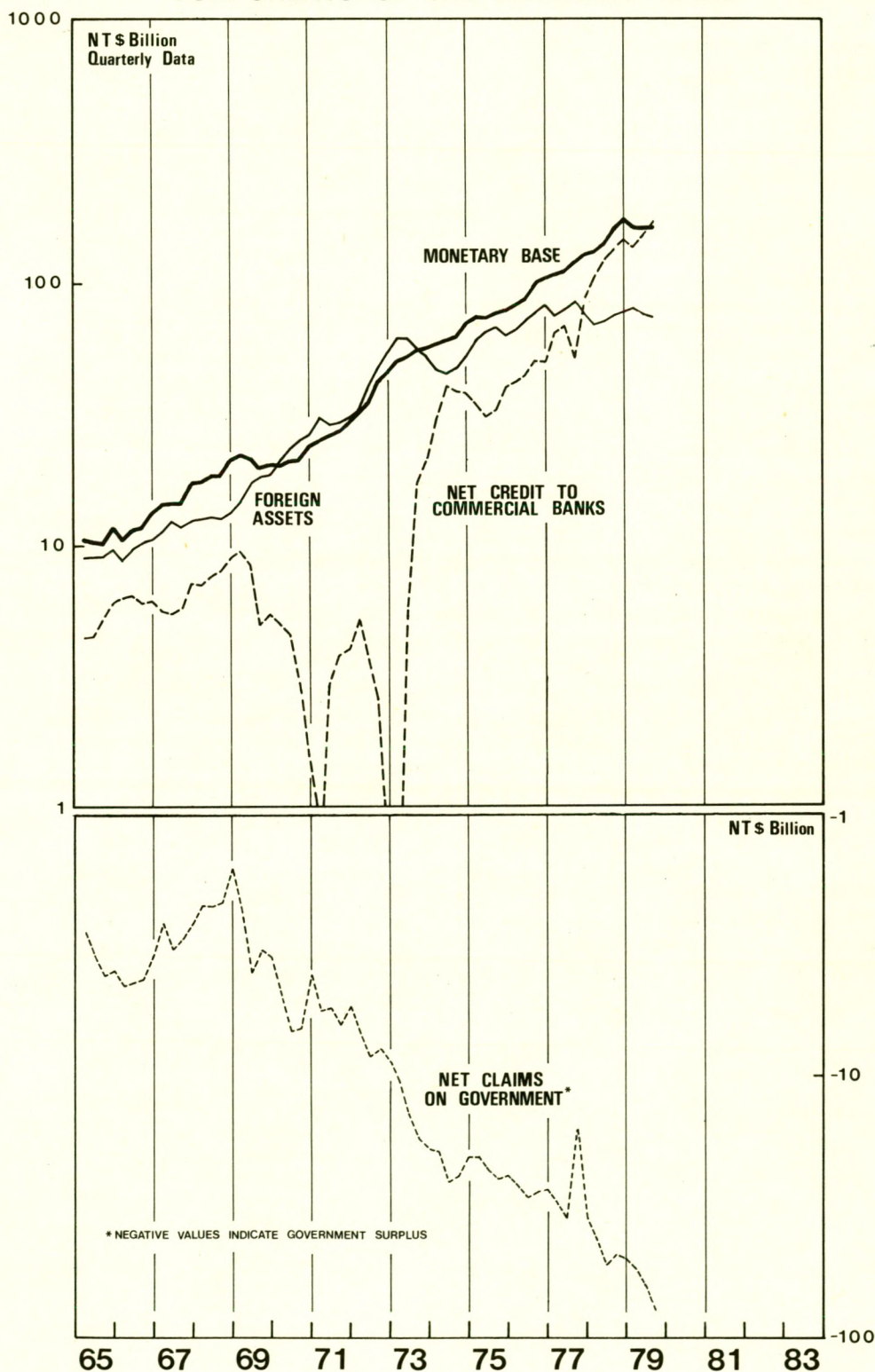
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* The rapid increase in the domestic component of the monetary base as a proportion of the total has been the dominant feature of Taiwan's monetary experience in the last six years. At the same time as providing the potential for increased central bank control over the monetary base, the increase in the domestic source has also been a mechanism for strengthening the government's control over Taiwan's economic resources. By utilising the government's surplus and the credit-worthiness of the Central Bank of China the government has effectively been able to reallocate resources to preferred sectors of the economy in the form of rediscounted central bank loans.

TAIWAN

CHART 6

COMPONENTS OF THE MONETARY BASE



sought (unsuccessfully) to reduce the expansionary impact which a balance of payments surplus usually has on the domestic economy by revaluing their currency. The Korean government, by announcing reduced economic and money supply growth "targets" in 1979 and 1980, initially endorsed the operation of the adjustment mechanism but then reversed their stance by devaluing the won in an effort to prevent an even tighter monetary squeeze. In other words, both economies have adjusted their exchange rates in an effort to pursue more independent monetary policies, but the Koreans encouraged monetary growth whereas Taiwan has attempted to curb it.

FORECAST: As in South Korea's case, the fact that the monetary squeeze and the decline in the real growth rate has occurred without a recession in the US is ominous. If the US does enter a recession in 1980 then Taiwan will undergo a further liquidity contraction since a pegged exchange rate implies that the Central Bank of China cannot follow an independent monetary policy. Even in the absence of a US recession it is unlikely that the official target of an 8% real growth rate during 1980 can be attained. This is principally because of the impact the oil price rise will have on real incomes in Taiwan this year, and because the authorities will probably not instigate a monetary expansion to offset the decline in the foreign component of the monetary base until inflation shows signs of having peaked. Similarly, regulated interest rates can be expected to lag the rate of price increases and hence will not fall until the second quarter of 1980 at the earliest.

The question then remains whether Taiwan, like South Korea, will feel it necessary to moderate a monetary induced slowdown by devaluing the NT\$. However, Taiwan is in a somewhat stronger position than South Korea was prior to its devaluation. The Taiwanese trade balance showed a small surplus in 1979 in contrast to the US\$5 billion deficit which occurred in South Korea. Taiwan's inflation rate, though rising, is also much lower than in Korea - consumer price inflation in Taiwan is currently 12% as compared with 19% in Korea - and is broadly comparable with that in the US, providing additional support for the view that the NT\$ is unlikely to be devalued in the short term.



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EDITORS:

John G. Greenwood

M.A. (Hons) Econ. Edinburgh
Research Economist, University of Tokyo
Economist at G.T. Management (Asia) Ltd.

Christian Wignall

B.A. Econ. Cambridge
Economist at G.T. Management (Asia) Ltd.

Hugh Sloane

B.A. Econ. Bristol
M. Phil. Econ. Oxford
Economist at G.T. Management (Asia) Ltd.

**CHARTS AND
STATISTICS:**

S.Y. Chan

Michael Wong

ADMINISTRATION:

Isabella L.Y. Ling

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KEY TO SYMBOLS USED IN THE CHARTS

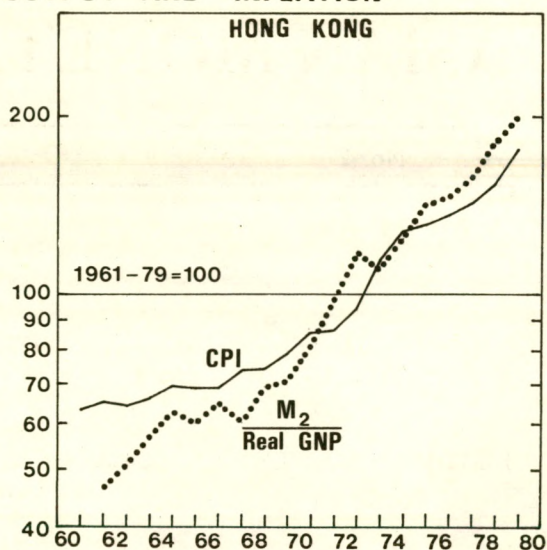
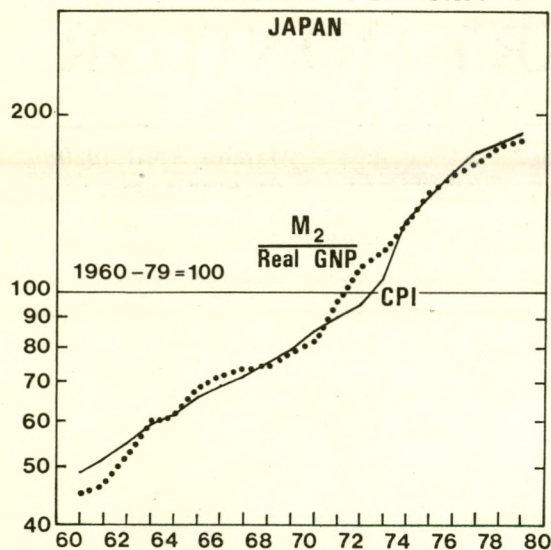
% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

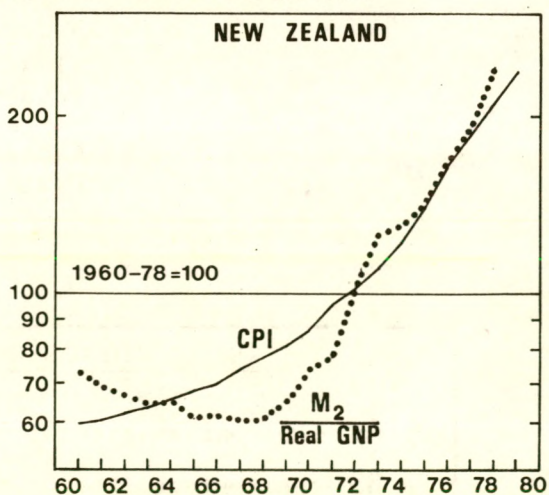
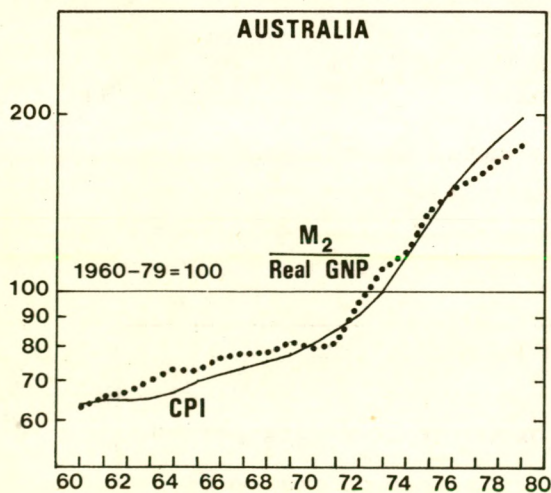
SAAR - Seasonally Adjusted at Annualised Rate.

MONEY PER UNIT OF OUTPUT AND INFLATION



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MONEY PER UNIT OF OUTPUT AND INFLATION



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REGIONAL SURVEY

SOME BASIC TRUTHS ABOUT INFLATION

Ask any government official or any businessman in the Asia Pacific region why his country is suffering inflation and you will almost certainly get the answer: "Oh well, our inflation is largely imported. It's not our fault. It's mainly due to oil price increases, and higher raw material costs. Higher labour costs and higher interest rates have also contributed. All these push up our costs, so we have to charge higher prices. And that's the story of inflation."

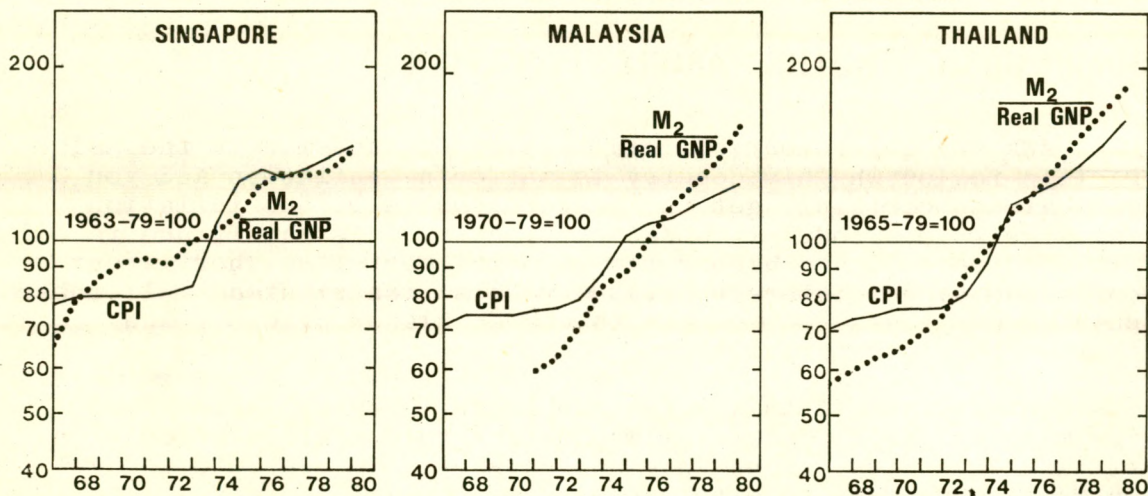
But is it? If this were true higher OPEC oil prices and raw material price increases would have very similar effects in similar economies. Hong Kong and Japan, which are both entirely dependent on external sources for oil imports, ought to experience roughly similar inflationary consequences with each successive OPEC price rise. Yet consumer prices in Japan rose only 5.7% in 1979 while prices in Hong Kong rose 15.3%.

Alternatively, Hong Kong and Singapore whose most important industries are manufacturing and services, and both of which are respectively entrepôts for the hinterland of Kwantung Province in China and Malaysia/Indonesia, would surely be similarly affected. But again, while consumer prices in Hong Kong were up by 15.3% in December 1979 on a year-to-year basis, in Singapore they were up by only 7.4%. Why the difference?

The explanation for the differing rates of price inflation in the region is to be found in the differing relative rates of money growth. As an initial statement one may say that countries with excessive money growth have experienced more inflation than those with more appropriate rates of money growth. What constitutes "excessive" growth and what constitutes "appropriate" growth of the money supply will be explained below.

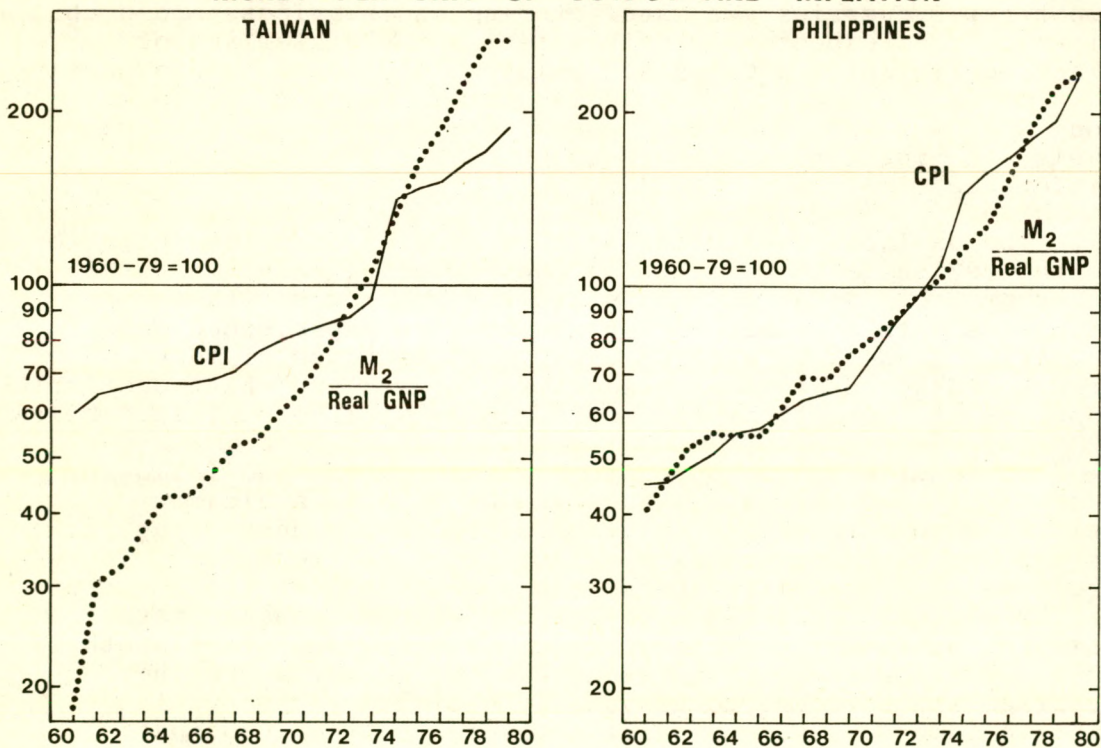
The charts on the opposite page and on the two following pages show that throughout the region there is a clear relationship between the quantity of money per unit of output on the one hand and the rate of inflation on the other. There are some striking differences in performance over time, but no matter whether countries have pursued pegged exchange rate policies or floating exchange rate policies, no matter whether they are resource-rich or resource-poor, no matter whether their governments are conservative, socialist, democracies, dictatorships or even colonial governments, the inescapable conclusion is that over extended periods of time there is a fairly persistent and stable relationship between the level of prices and the quantity of money per unit of output. (In all the charts price levels are measured by the consumer price index (CPI), money is measured by M_2 using the IMF definition (with a couple of exceptions), and output is measured by real GNP.)

MONEY PER UNIT OF OUTPUT AND INFLATION



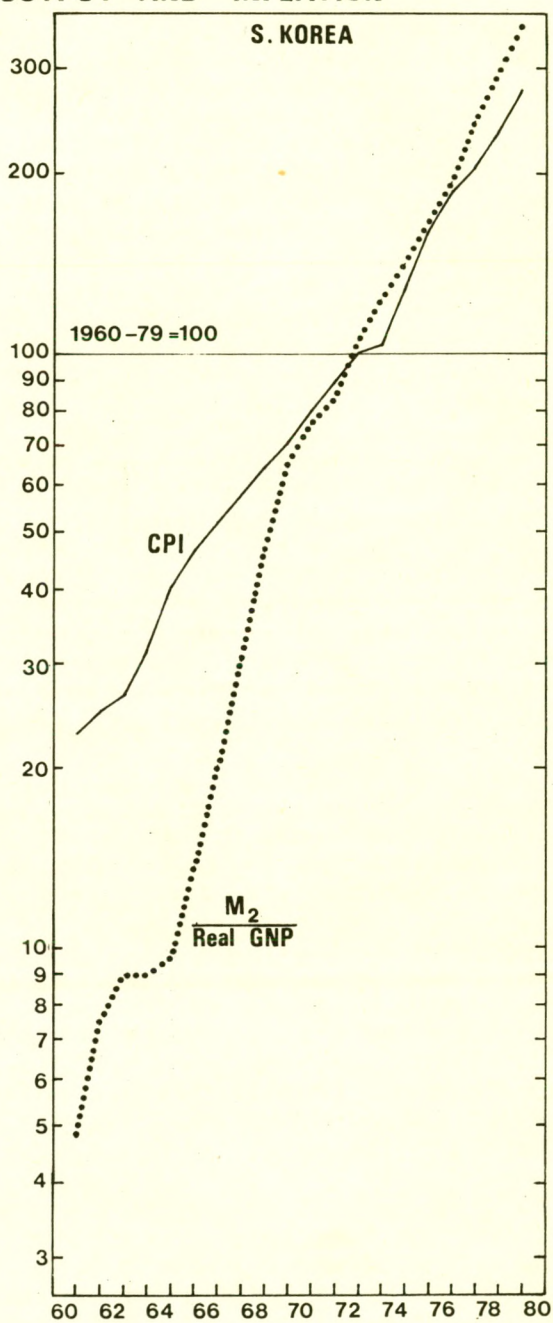
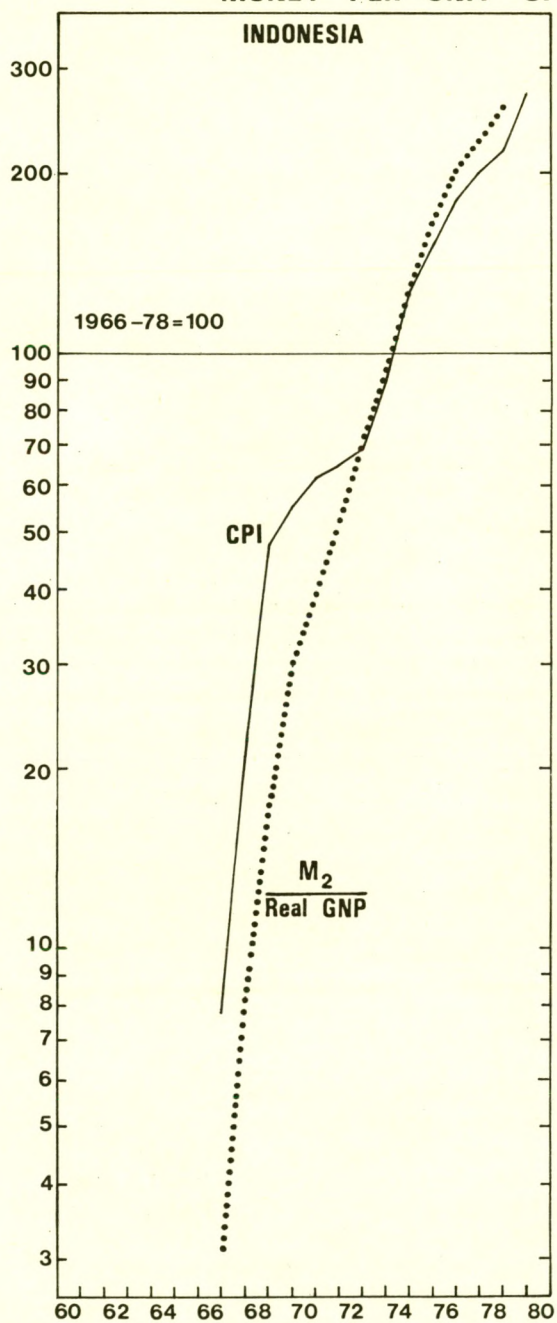
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MONEY PER UNIT OF OUTPUT AND INFLATION



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MONEY PER UNIT OF OUTPUT AND INFLATION



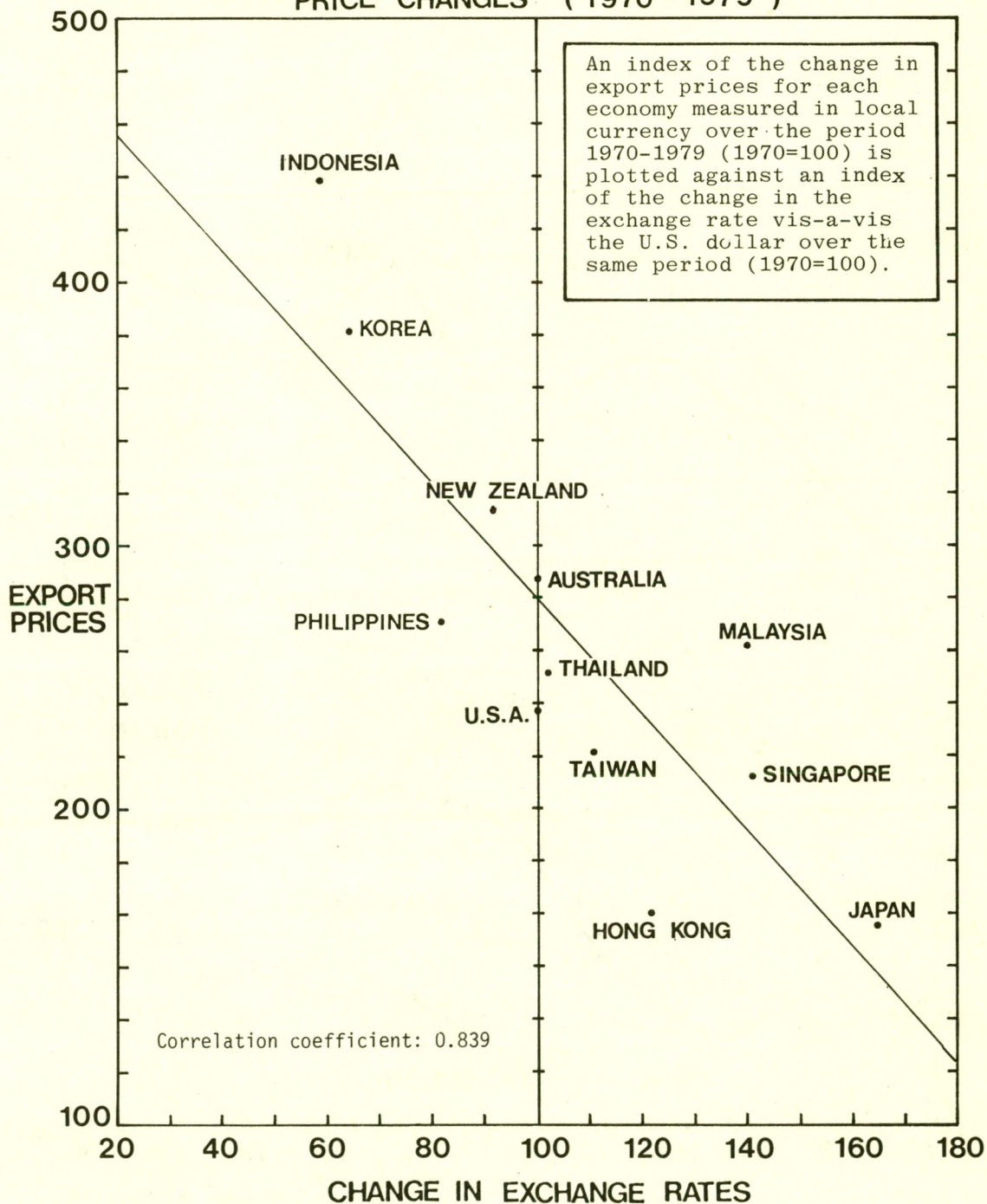
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In general one may also go on to say that the higher the relative rate of money growth, the higher the rate of inflation, and the higher the rate of inflation the greater the depreciation of the currency - again over any extended period of time. This proposition is illustrated in the chart on the opposite page. Here we take an index of export prices in each country (1970=100) and compute how much it has increased over the whole period (1970-79), plotting this against the vertical axis. On the horizontal axis we show how much the currency of the country in question has appreciated or depreciated against the US\$ over the same time period - again on an index basis with 1970=100. (For aficionados of AMM this is essentially an update of the chart shown in Vol. 2 No. 4, July-August 1978, which showed the same set of relationships in terms of percentages rather than as indices.)

These propositions are obviously somewhat oversimplified, or else the correlation between price increases and changes in inflation rates would be much closer than it actually is. Also one must be aware that the data we are comparing is of differing quality between countries and of differing quality within one country over periods of time. (For example the construction of price indices in Japan is regularly revised to ensure that the indices properly reflect the changing patterns of expenditure, while so far as we know the Thai and Indonesian indices have not been reconstructed at all throughout the decade 1970-79.)

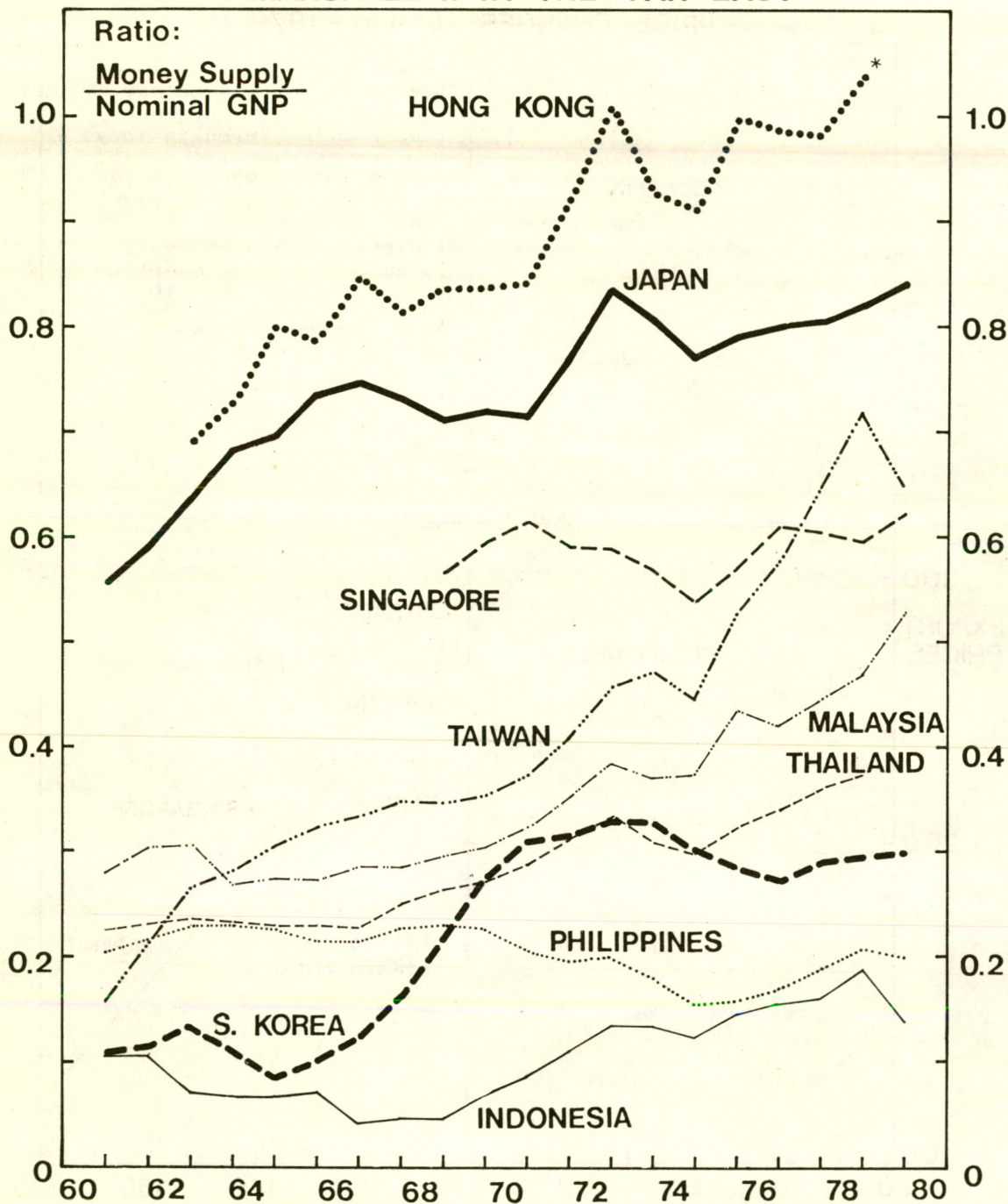
Returning to the first link in the chain - the relation between money and prices - it appears that in societies whose economies are growing rapidly and where individuals' financial asset holdings are small, there is a tendency for individuals (and often corporations) to try to accumulate money balances relative to their annual income (or revenue). This means that any economy in this situation can afford to allow the money supply to grow faster than would normally be necessary in a society where the "demand for money balances" was not so voracious, because even a rapid growth of money relative to real income growth will be "absorbed" by people adding to their money balances. A good example of where this applies is Taiwan. The chart on the following page shows that in Taiwan Marshallian k (i.e. the average nominal money balances held per unit of nominal income by the society as a whole) has been rising very steeply over the past decade. In fact over the decade as a whole the compound rate of growth of money averaged 27.1% p.a. while the compound real economic growth rate averaged 9.0% p.a. The difference between the two must be explained either by changes in the level of prices (the compound annual rate of inflation) or by the persistent accumulation of money balances relative to income as the Taiwanese have grown more prosperous, or by a combination of the two. From the chart on page 4 we know the inflation has been different at different periods, and we also know from the Marshallian k chart on p.8 that there has been a steady build-up of money balances. So the answer is that despite "excessive" money growth, Taiwan has been to some extent let off the inflationary hook by the willingness of the people to build up

THE RELATIONSHIP BETWEEN EXCHANGE RATES AND EXPORT PRICE CHANGES (1970 - 1979)



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MARSHALL K IN THE FAR EAST



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* Due to the significant shift of deposits from Licensed Banks to Deposit-Taking Companies in 1978-79 the consistency of the ratio of M_2 to real GDP for Hong Kong has been undermined. Even so the ratio rose strongly relative to its trend in 1978 suggesting the possibility at some stage in the future of high inflation rates such as the economy is currently experiencing.

their money balances.

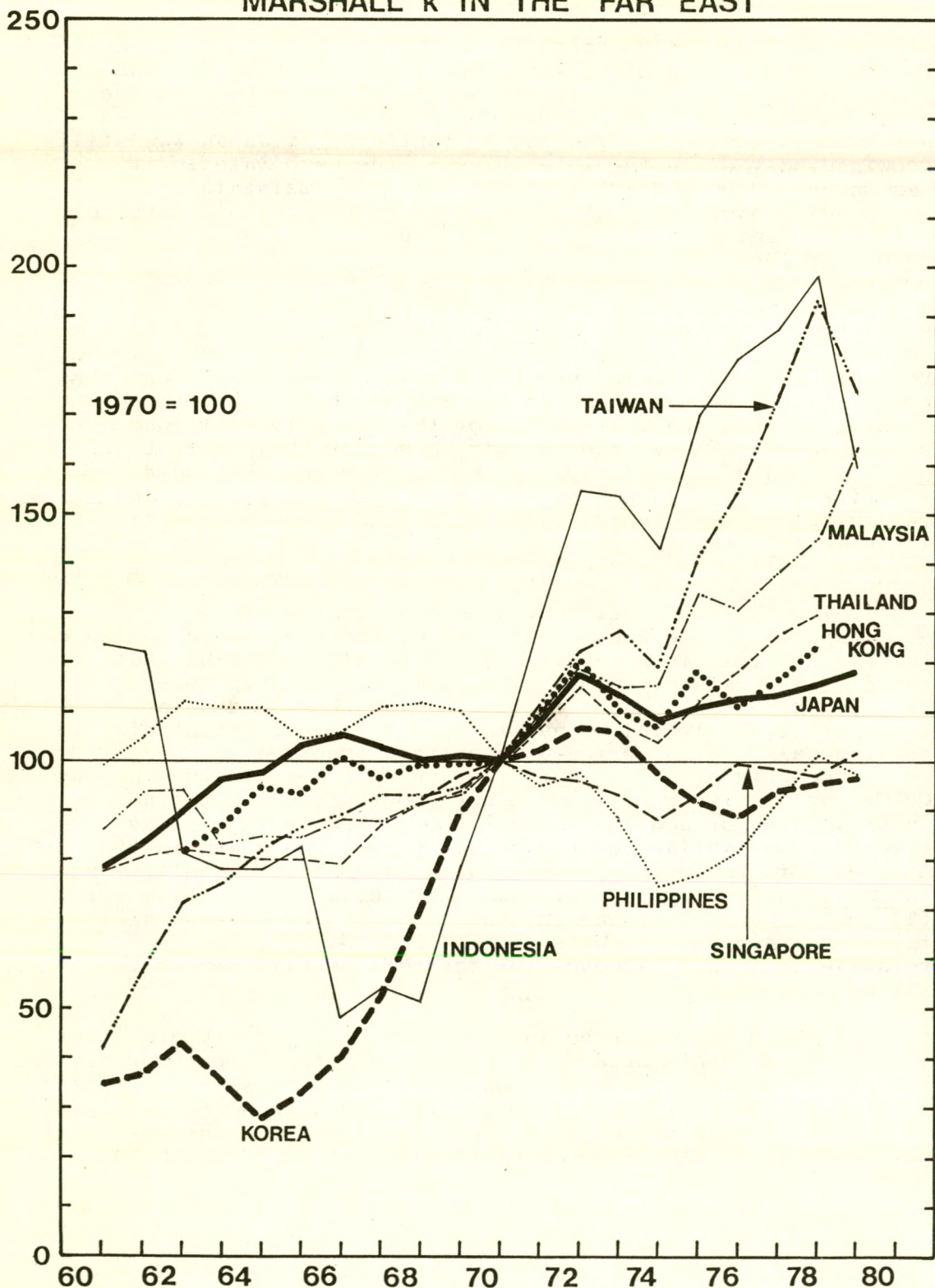
Now contrast the experience of Taiwan with that of Japan. Up until the mid-1960's Marshallian k (M_2 /Nominal GNP) was rising quite strongly at approximately 4% per annum. Since about 1965 the rate of increase of Marshallian k has slowed abruptly to about 1% per annum so that even if Japan was still growing today or in the late 1970s at the same rate as it was in the 1950s and 1960s it would have to maintain a relatively lower money growth rate in order to avoid rates of inflation similar to those experienced on average through the 1950s and 1960s.

This type of analysis could be applied to all the economies of the region, and it could also be extended to compare the degree of fluctuation about the trend in the ratio of the Money to Nominal Income over the course of any single business cycle. That, however, is not our purpose here. The immediate task is to show that, allowing for the trend in real income growth in an economy, and allowing also for the apparent desire of individuals to build up the amount of money they hold relative to their income as they grow more prosperous, any remaining "excess" money growth will tend to show up ultimately in a higher rate of inflation.

Conclusion: Irrespective of different institutional arrangements in the banking systems of the various economies of the Far East, it is a finding common to all economies that there is a reasonably close long term relationship between excess money growth and inflation. In other words, in a fundamental, analytical sense inflation - a persistent rise in the general level of price - is neither imported, nor created by greedy entrepreneurs, nor by grasping trades unions, nor by OPEC, but simply by "excess" money growth relative to the "appropriate" or non-inflationary money growth rate. The divergence of inflationary experience over the years in the Asia Pacific region emphasises the point that it is differences in local money supply growth rates which, after allowing for (1) real growth rates and (2) the tendency for people in rapidly developing economies to build up money balances relative to income, account for most of the differences in inflation rates.

It would therefore be incorrect to say, for example, that because Hong Kong's crude oil, petrol and other import prices had risen by $x\%$ on average, that $y\%$ inflation was inescapable. If that were so, it would also be true for Singapore, or Japan, or any other economy, and yet those two economies currently have much lower inflation rates than Hong Kong, despite the

MARSHALL k IN THE FAR EAST



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fact that Singapore is an even more "open" economy than Hong Kong*, and despite the fact that over the past eighteen months the yen has depreciated more than the Hong Kong dollar thus presumably making Japan more vulnerable to so-called "imported inflation".

The lesson, then, is that not only is inflation a monetary phenomenon in the sense that it is associated with money growth rates which are persistently in excess of the desirable, non-inflationary money growth rates, but inflation is also a phenomenon which is domestically created. Insofar as monetary growth is capable of control by the authorities in each economy, it follows that generalised inflation is their responsibility, and not the fault of anyone in the private sector.

* Ratio of Total Exports + Imports to GDP

	<u>Hong Kong</u>	<u>Singapore</u>
1978	1.833	2.907
1979	1.875 (est.)	3.569

JAPAN

THE RECOVERY OF CORPORATE PROFITS

In spite of a rapid turnaround in the balance of trade, a 30% depreciation of the yen, a huge increase in raw material costs, a deterioration in the terms of trade, a slight slowdown in the money supply, and an increase from 3.5% to 6.25% in the official discount rate, last year was one of continuing recovery for Japanese manufacturing industry. Manufacturers' operating profits increased by nearly 60% during 1979 and finally recovered the peak levels of profitability they had enjoyed in 1973.

This revival in manufacturing profitability during the current business cycle has been associated with a reversal of a discouraging trend that characterised the earlier part of the 1970s whereby an increasing share of National Income was received by employees, and a decreasing portion accrued to the corporate sector. For example, despite the fact that manufacturing profitability reached cyclical highs at the end of 1973 and during 1976, the share of national income earned by Japanese companies in these years declined, as shown in the final column of Table 1.

Table 1

NATIONAL INCOME SHARES (%)

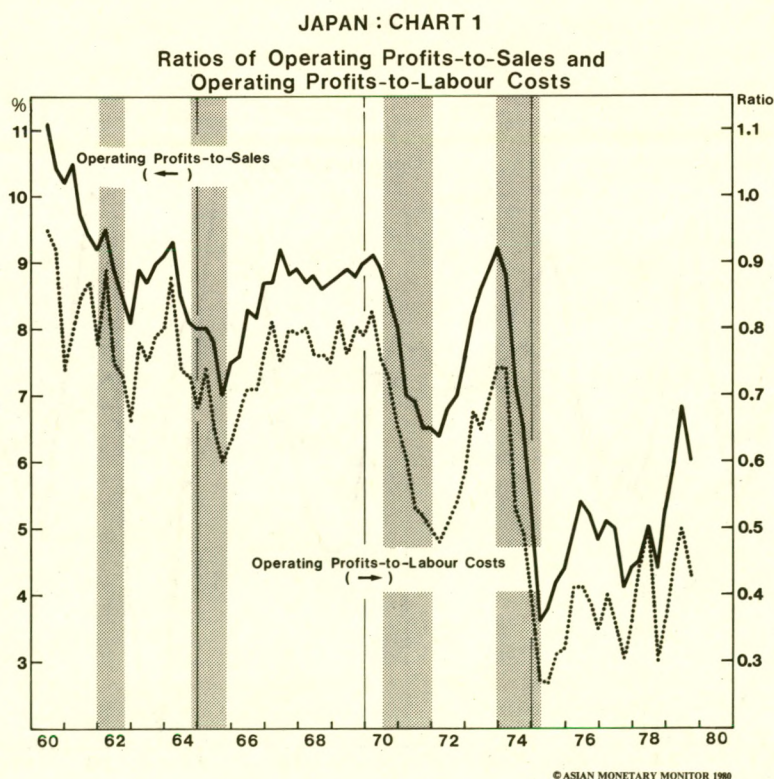
End of	Compensation of Employees	Income from Property	Income from Unincorporated Enterprises	Income from Private Corporations
1970	55.0	8.8	22.1	14.7
1971	58.5	9.9	19.8	11.2
1972	56.7	9.8	21.7	12.5
1973	60.1	9.9	20.9	10.0
1974	65.9	11.0	19.5	3.7
1975	66.3	11.1	18.4	4.4
1976	67.8	11.1	18.2	3.0
1977	67.0	10.3	18.0	4.7
1978	66.2	10.1	17.7	5.9
1979 (est.)	63.5	10.0	18.0	8.5

The reduction in the share of national income earned by unincorporated enterprises mainly reflects the secular decline in the aggregate size of Japanese small businesses which has been going on for many years. The proportion of national income accruing to the business sector as a whole (the last two columns of Table 1) fell considerably from 36.8% in 1970 to a low of 21.2% at the end of 1976. Almost the whole of this reduction was effectively transferred to wage and salary earners whose share of national income rose by nearly 25% over the same period. Over the course of the present business cycle this increase has been reversed, but although the level of

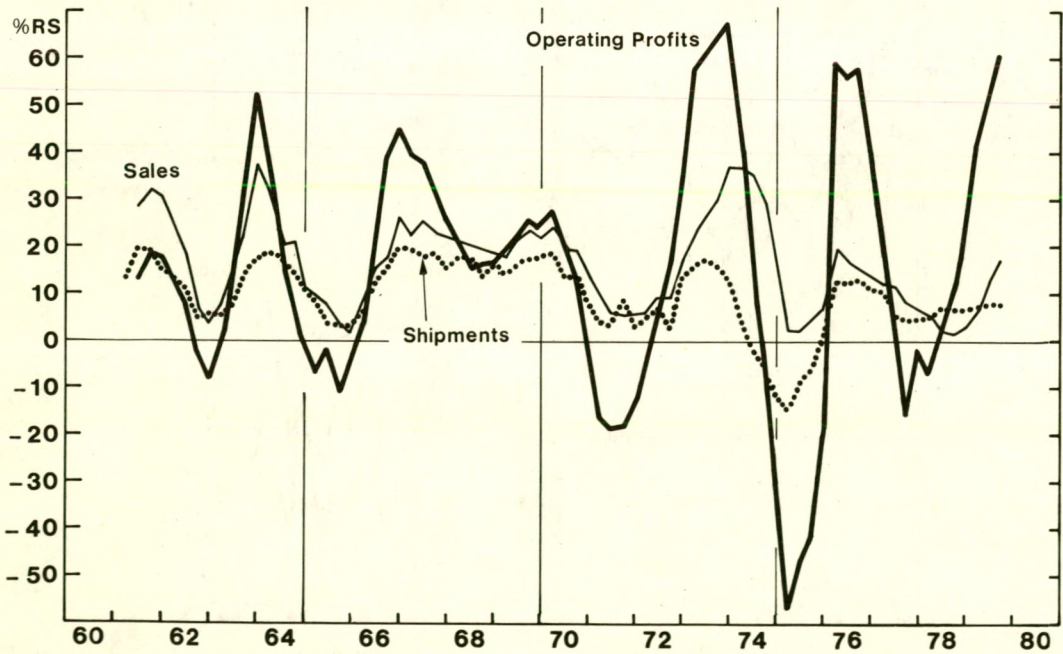
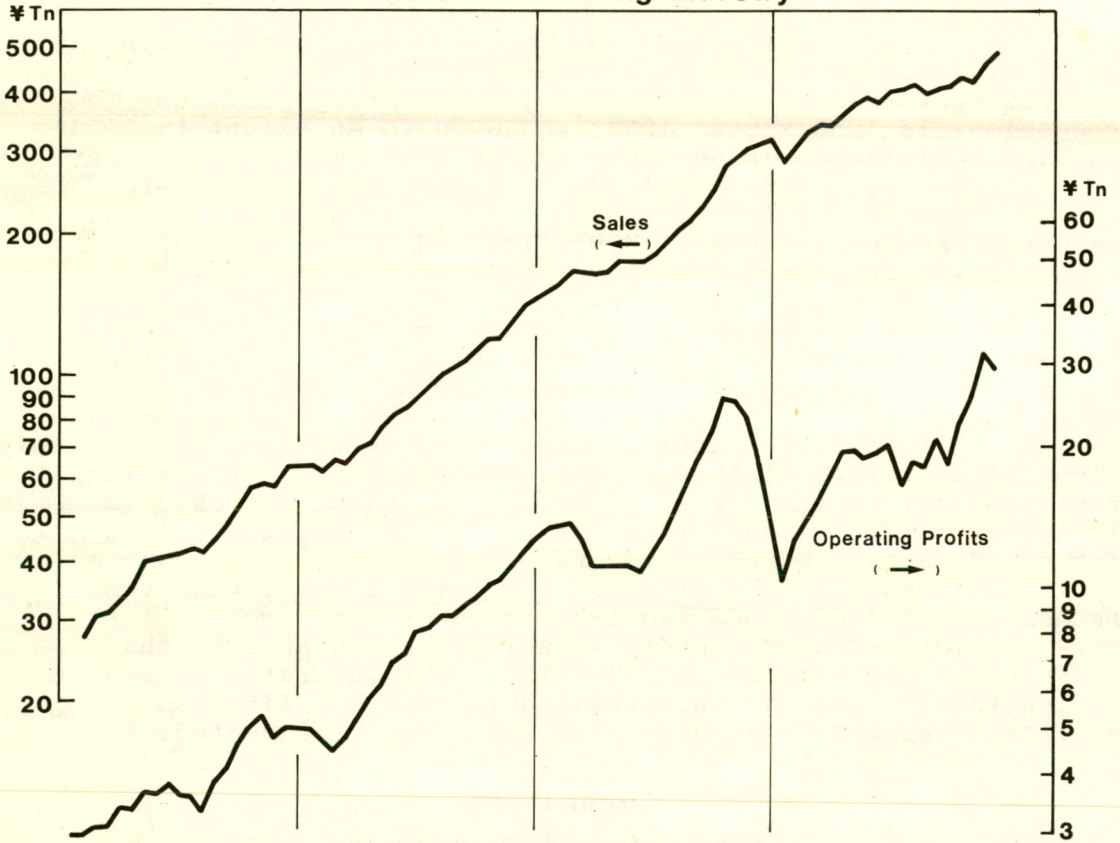
manufacturers' profits has returned to their 1973 position, the corporate sector has so far failed to regain the share of national income it forfeited so dramatically in 1974.

The failure of the Japanese business sector to regain its share of national income in 1975 and 1976 is a particularly notable feature of that business cycle. During previous recessions in 1958, 1962, 1965, and even to an extent in 1971, the share of labour in national income increased and the share of the corporate sector declined, but these movements were quickly reversed in the first year or so of industrial recovery, during which period profits and sales revived, and labour costs sustained a cyclical fall.

The shift in income shares away from the business sector in favour of labour is reflected in Chart 1 which shows the ratios of operating profits-to-sales and of operating profits-to-labour costs. If we examine the ratio of operating profits-to-sales for Japanese manufacturing industry we have a reasonably clear illustration of the cyclical behaviour of manufacturing profitability in the period up to and including the 1973-74 recession. (The broader ratio of operating profits-to-sales for all Japanese industry over the same period reveals a similar cyclical trend but with greater volatility.) Following the recessions of 1962, 1965 and 1971 the operating profits-to-sales ratio increased rapidly to a level comparable to that existing before each slump. The fact that the ratio increased during the recovery of industrial output is a reflection of profits growing faster than sales, as would be expected.



JAPAN : CHART 2
Operating Profits, Sales and Shipments
in the Manufacturing Industry



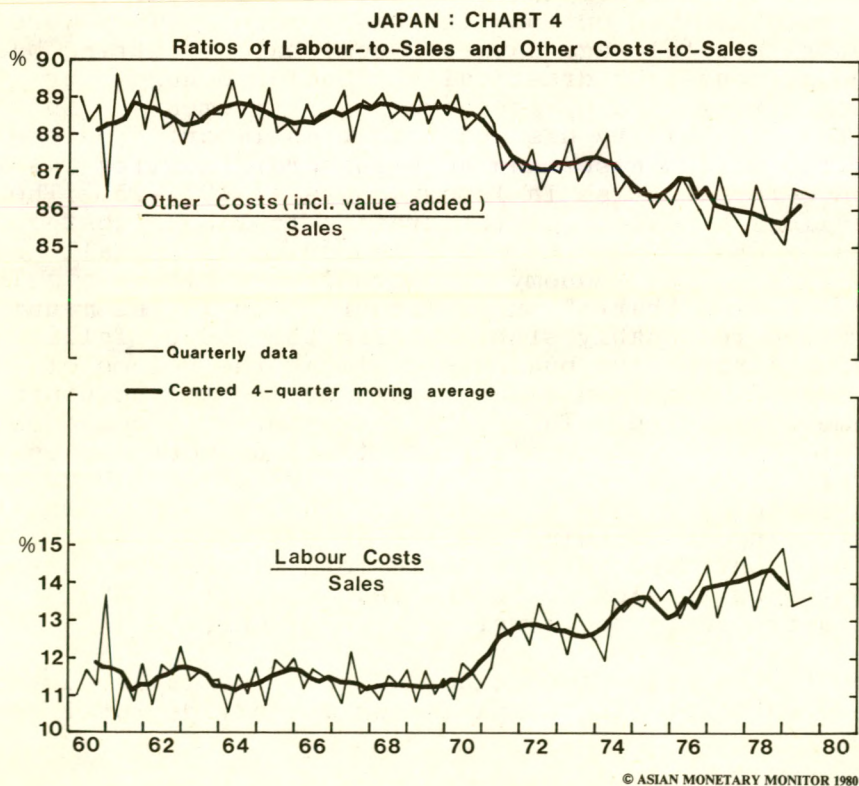
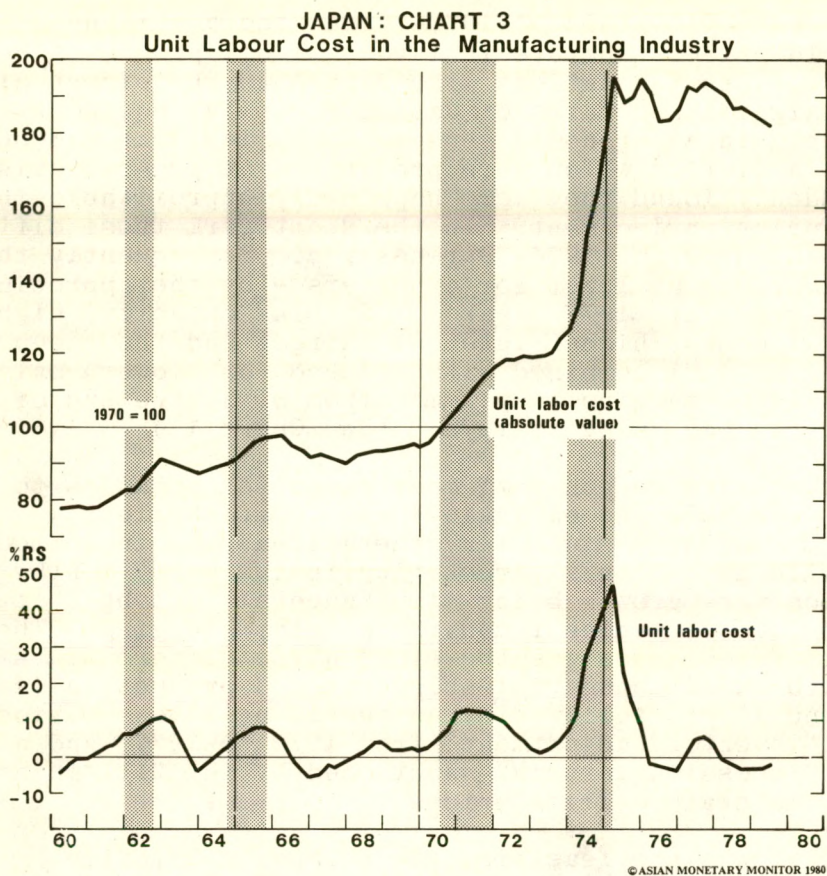
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The first oil crisis of 1973-74 and the accompanying shift in the world price structure in favour of oil-producers and against manufacturing nations like Japan had the effect of rendering significant parts of Japanese capital equipment 'obsolescent' in an economic sense. Companies that had built plant and facilities which were profitable at pre-oil crisis prices suddenly found they were hopelessly unprofitable in the new world price environment. In the short term these difficulties were compounded by the 1974-75 recession. Subsequently they were aggravated - at least for exporters - by the appreciation of the yen from late 1977 onwards. Surplus capacity, higher raw material costs, higher interest charges and the steep rise in wages in 1974-75 combined with reduced (or slower) sales caused operating margins to plummet from 9% at the end of 1973 to 3.5% at the beginning of 1975. (See Chart 1.)

The immediate response of most Japanese companies to the crisis of late 1973 and early 1974 was to stockpile raw materials in anticipation of a generalised rise in commodity prices. With inflation sky-rocketing in the early months of 1974 and monetary growth being simultaneously cut back it was not long before companies found their sales plunging. The second set of responses was therefore quite different. A drastic cutback in industrial shipments and production (see Charts 2 and 7) was followed by an agonisingly long period of so-called "inventory adjustment" from 1975 to 1977, and a resort to "recession cartels" sanctioned by the MITI in an attempt to maintain selling prices.

Since it was not feasible, given Japan's lifetime employment system, for companies to lay off employees, Japanese companies faced limited options in this respect. They were able to restrain total wage payments somewhat by cutting back on overtime payments, by drastically reducing bonuses, by delaying new hirings and by accelerating retirements. But their limited flexibility has meant that an important element in the decline of Japanese manufacturing profitability was the dramatic once-for-all rise in labour costs in 1974-75. The typical cyclical behaviour of the profits-to-labour cost ratio illustrated in Chart 1 has been for labour costs to fall and profits to rise as the economy recovers from a slowdown. Thus, as may be seen from Chart 3, unit labour costs in the manufacturing sector remained reasonably stable during the 1960s, falling during the upswing of the business cycle as the volume of output increased, and then rising again during the downturn as sales volume contracted. This is a characteristic consequence of the lifetime employment policy practised by most Japanese manufacturers where there is almost no "firing" of labour at times when capacity utilisation falls. The pattern of falling unit costs during the upswing and rising unit costs during the downswing has continued in more muted form since 1974, but still shows up quite clearly in the year-to-year (% RS) changes illustrated in the lower section of Chart 3.

To see the relative importance of the rise in labour costs for Japanese manufacturing companies we may divide total cost



of inputs and value added into four elements:

$$\text{Sales} = \left[\begin{array}{c} \text{Labour} \\ \text{Costs} \end{array} \right] + \left[\begin{array}{c} \text{Raw} \\ \text{Material} \\ \text{Costs} \end{array} \right] + \left[\begin{array}{c} \text{Capital and Other} \\ \text{Financial charges} \\ \text{inc. Rent etc.} \end{array} \right] + \left[\begin{array}{c} \text{Value} \\ \text{Added} \end{array} \right]$$

From available statistics labour costs are the only element from the right-hand side of the equation which can be separated out, so the other components of the right-hand side of the equation must be combined into a residual which we shall call simply "other". Re-writing the equation we have therefore:

$$\text{Sales} = \left[\text{Labour Costs} \right] + \left[\text{Others inc. Value Added} \right]$$

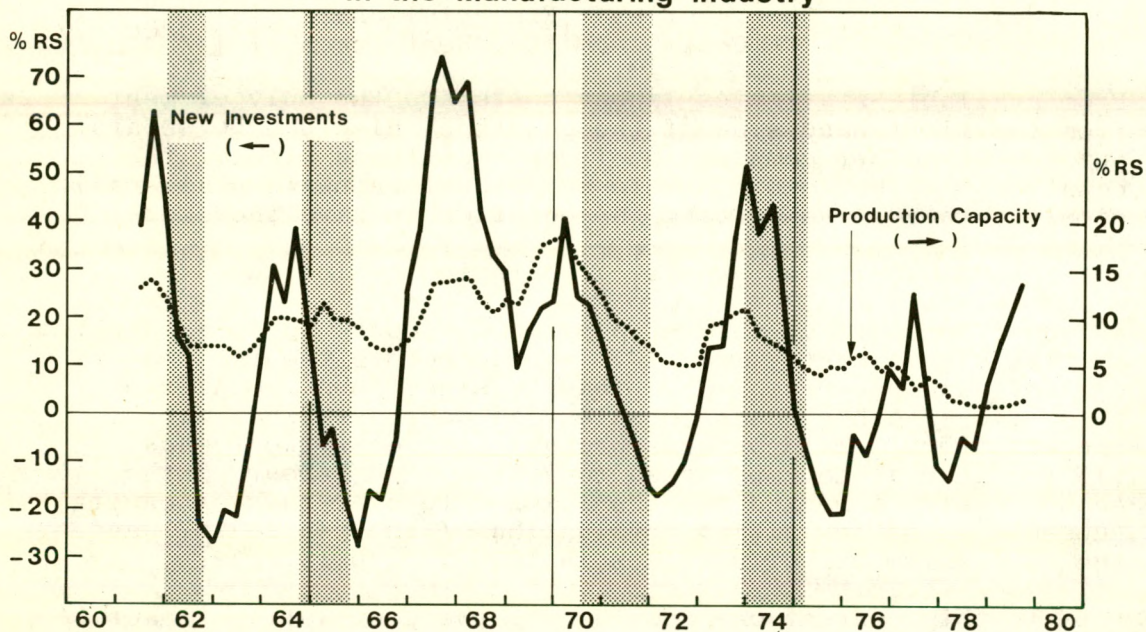
As shown in Chart 4, the ratio of labour costs to sales started to rise significantly from 1971 - well before the first oil crisis - and has risen quite steadily since then. Conversely the ratio of other costs to sales has decreased in a mirror-image pattern. This process probably reflects two trends: (1) the gradual move by Japan towards a high labour cost economic structure and (2) the lower rate of return on capital subsequent to the initial revaluation of the yen in 1971 and the successive oil price hikes in 1973/74 and 1978/79.

In this context one should note the contrasting impact on corporate activity of the economic adjustment mechanism under fixed and floating exchange rate regimes. Whilst the yen was pegged to the US dollar the mechanism whereby the prices of Japanese products were maintained relative to their foreign counterparts operated in such a way that changes in aggregate demand and the overall price level were mainly the result of changes in the volume of output. In other words, Japanese business cycles before 1973 were characterised more by changes in output volume than by changes in relative prices. The move to floating exchange rates from August 1971, which accentuated the increased volatility of raw material prices altered this basic pattern. The old mechanism which induced economy-wide changes in the growth of industrial output no longer operates so that there is now more diversity in Japanese manufacturers' profits due to relative price variations.

If the economic adjustment mechanism now operates more through changes in relative prices than through variations in output then we have the basis for explaining structural shifts in the economy. Changes in the relative price of labour, raw materials, and capital equipment created the incentive to alter the product mix of Japanese manufacturing industry. Whereas during the 1960s it is broadly true to say that Japanese GNP growth was geared to the fortunes of high output, low value added industries such as steel, ship-building and base chemicals, the emphasis in the latter part of 1970s has switched to assembly industries producing higher value added products, such as home electrical goods, cameras, autos, precision instruments, office equipment and small computing machines.

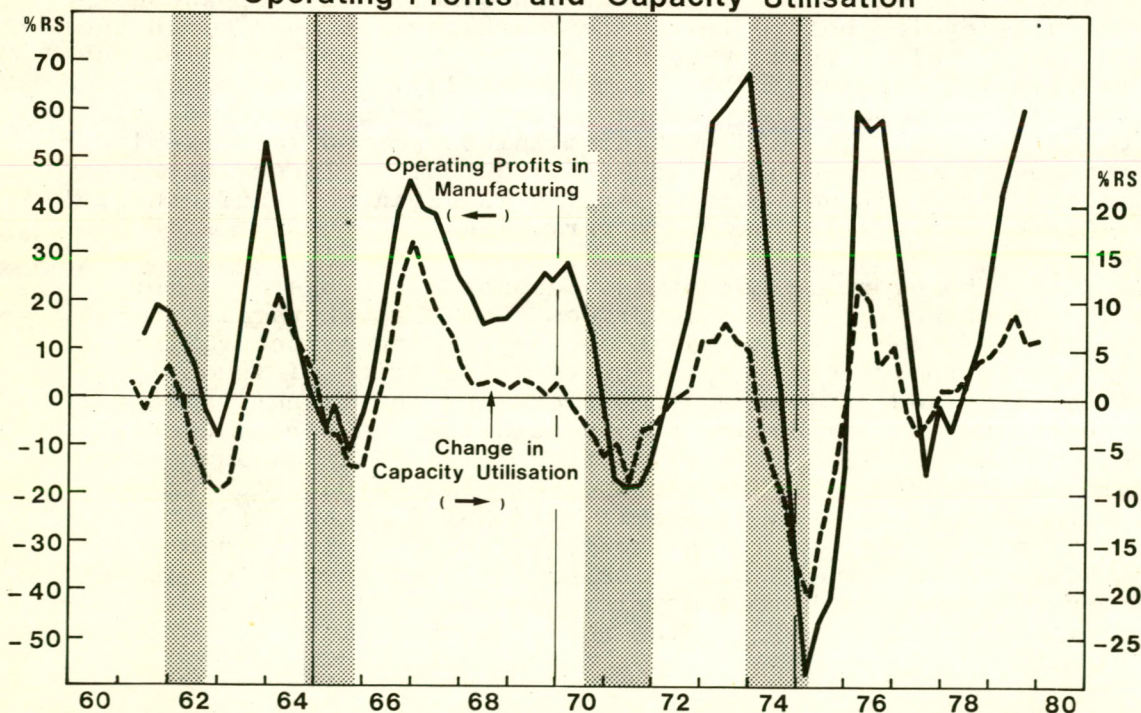
Relative price changes have also induced changes in production techniques in an effort to reduce costs. A good

JAPAN : CHART 5
New Investments and Production Capacity
in the Manufacturing Industry



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JAPAN : CHART 6
Operating Profits and Capacity Utilisation



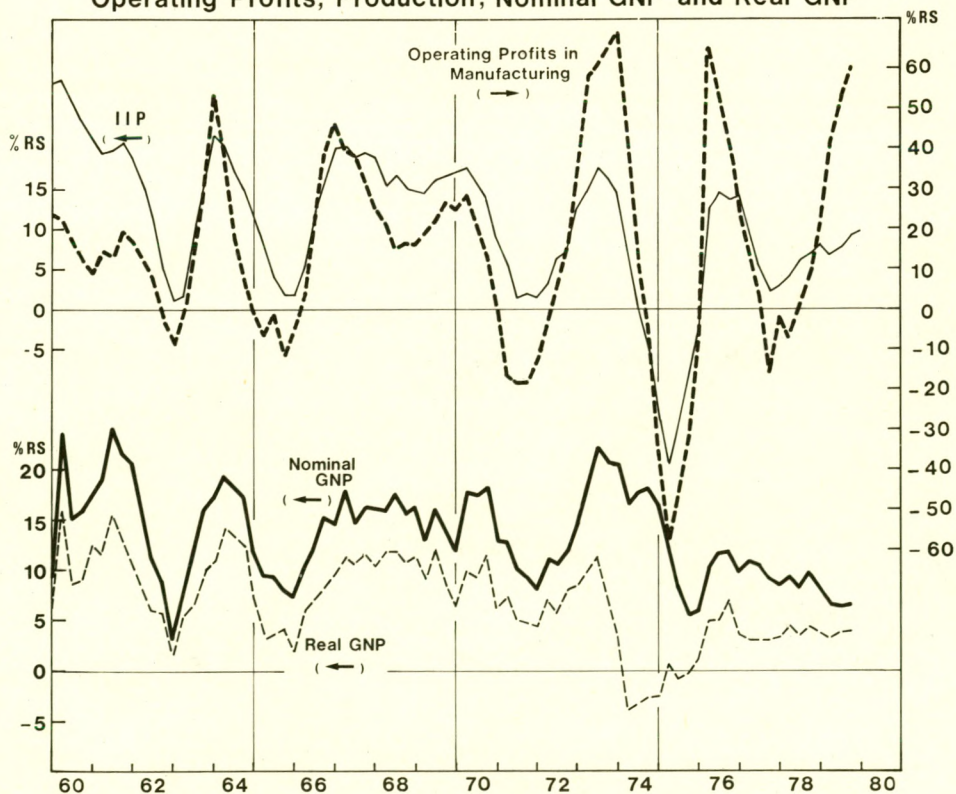
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example of costs being reduced by changes in production technology is in the steel industry. By switching to continuous casting, the steel industry has been able to reduce its breakeven level from 90% in 1973 to 70% in 1979 and is aiming to achieve a breakeven level of 65% in 1982.

The trend towards increasing profitability by reducing costs and the introduction of new high value-added product lines rather than through increasing the volume of low value-added output has been very widespread in Japan in recent years. Chart 5 shows that the rate of growth of productive capacity in the manufacturing sector has been on a declining trend since the end of 1973, and in the last three years has increased by only 5% compared with a 28% increase in new investment. The slower growth of manufacturing capacity since 1973 coupled with the fact that the majority of new investment has been geared towards improving plant efficiency, is a further contrast with the earlier period.

With relative prices becoming a more important determinant of profitability we can expect a greater diversity amongst Japanese companies' earnings and profits performances than has been the case hitherto. This has important implications for the stock market. The contrasting performance of, for example, Japanese utilities, which have suffered heavily from the rise in the relative price of imported raw materials, and automobile

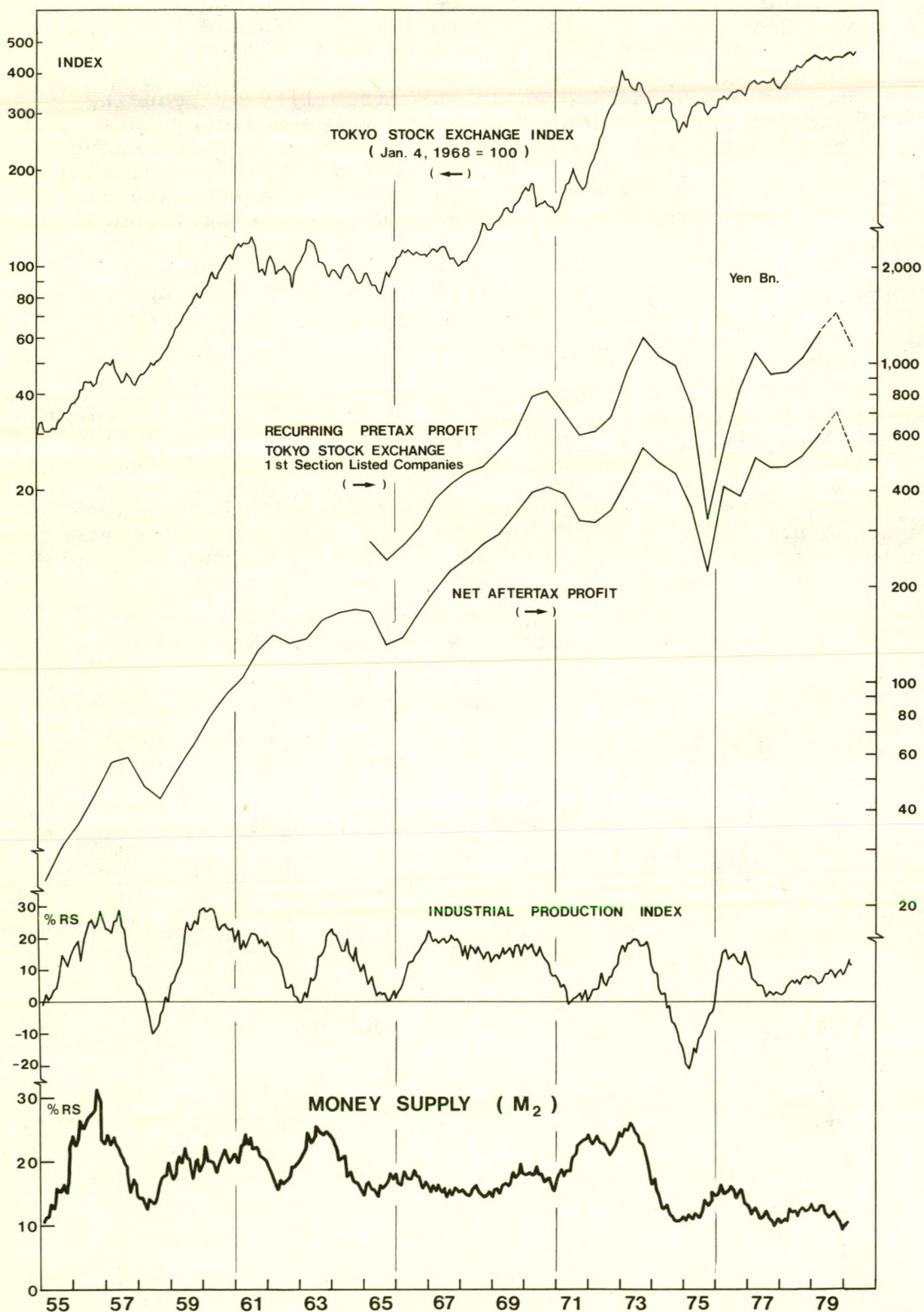
JAPAN : CHART 7
Operating Profits, Production, Nominal GNP and Real GNP



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JAPAN

CHART 8 : MONEY, OUTPUT, PROFITS AND STOCK PRICES



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manufacturers which have benefited from favourable export prices and more efficient production methods, bears witness to this. So too does the 22% rise in business failures since the third quarter of 1978, which occurred during the period when overall profit levels increased so dramatically.

FORECAST: This diversity in corporate earnings implies that, on a fundamental view, the possibility of further broadly based movements in stock prices is reduced. The decision to allow the yen to float effectively abandoned the mechanism whereby overall increases or decreases in aggregate demand affected all manufacturing sectors to a greater or lesser extent simultaneously. Thus with changes in aggregate demand becoming less significant and with relative price changes playing a more important role in the economic adjustment mechanism, the profitability of individual manufacturing sectors will become more independent of one another. The contrasting effects of the relative price of the yen on importing and exporting concerns provide the most obvious examples of sectors where profitability can diverge significantly whilst the growth of aggregate demand in the domestic economy remains constant. Differential price effects of this kind will be found increasingly throughout the economy.

As the Japanese economy gradually adapts its capital equipment and its output to the needs of a greatly changed world price structure on a secular basis, the corporate share of national income will gradually be restored as margins recover, while labour's share of national income can expect to be gradually eroded. In the meantime, within the context of a prospective cyclical slowdown in profit growth in 1980, relative price movements and the incentives they create for changing production techniques and varying the composition of output will produce widely disparate profit performances among Japanese companies.

THAILAND

AN INVOLUNTARY SQUEEZE

External Sector

Any developing country where agricultural produce and crude materials form 65% of exports, which possesses a small and undiversified industrial base, and which lacks domestic oil reserves must be considered a possible candidate to experience a recession along with the major developed economies. This is particularly likely to be true in the case of Thailand which, as a consequence of effectively pegging its domestic currency to the US dollar, is unable to follow an independent monetary policy in anything but the short term.

Chart 1 indicates that on average, the Thai monetary authorities have followed a more accommodating monetary policy in the latter half of the 1970s as compared with the period up to 1972. The increase in nominal GDP which this policy engendered has resulted in generally higher rates of inflation, a weakening balance of payments and an accelerating decline in foreign reserves. As a consequence, if and when Japan and Germany slow down, and the US and UK move into recession, it appears that on balance Thailand is in a relatively worse position from which to face a decline in world trade than it was in 1973. Table 1 compares a series of key economic indicators at the end of 1973 and 1979 in order to illustrate this view.

Table 1

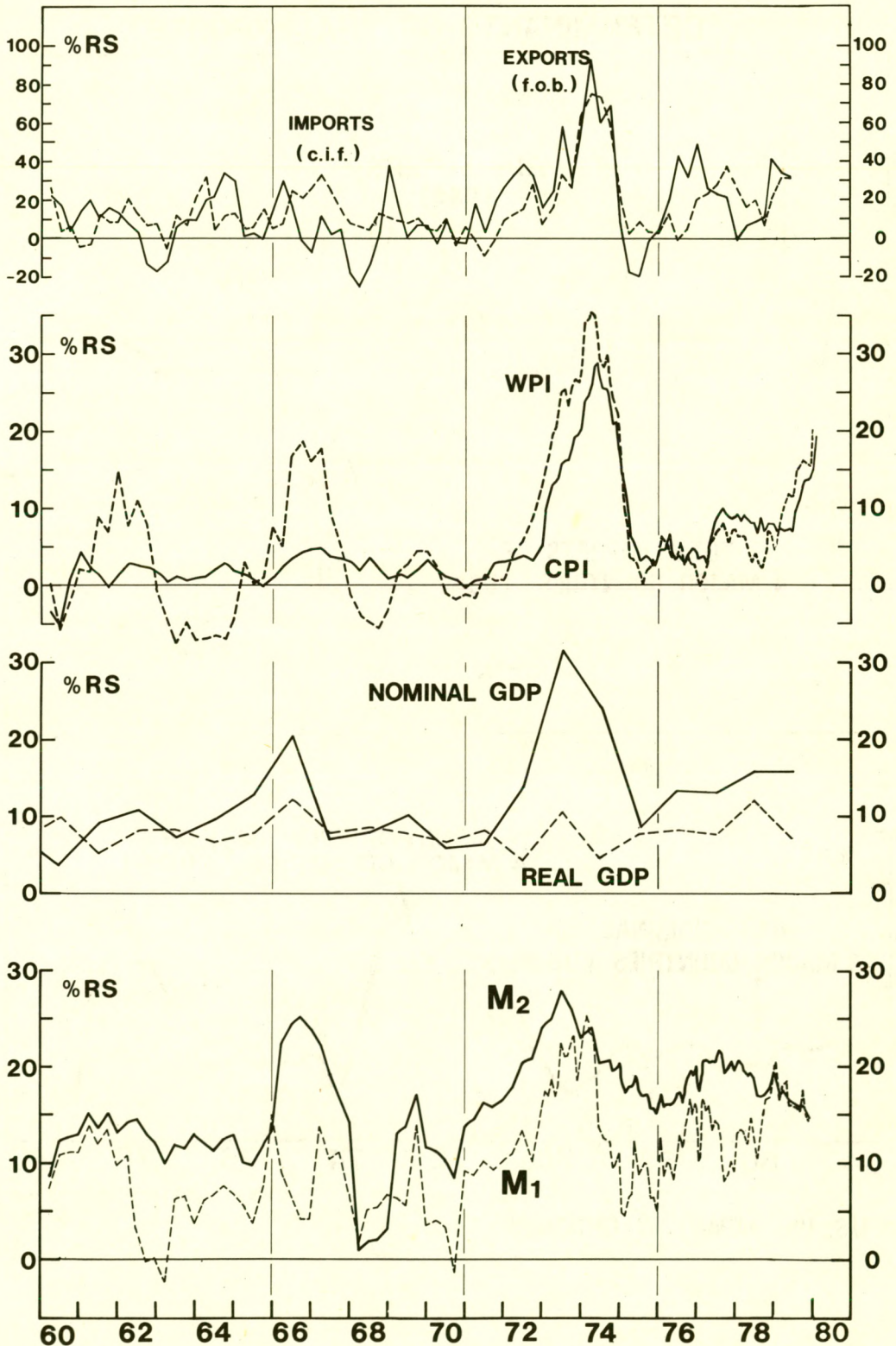
COMPARISON OF MAJOR ECONOMIC INDICATORS IN 1973 AND 1979

	<u>1973</u>	<u>1979</u>
Average money supply growth during previous two years (% RS) M_1	17	17
Inflation (Bangkok CPI, % RS) M_2	21	18
Interest rates (commercial bankers' "call money")	20	14
Average real GNP growth during previous five years (% RS)	9.3	14.96
Growth of agricultural output (% RS)	7.1	6.8
Trade deficit (million baht)	7.5	7.5
Balance of payments (million baht)	10,802	18,000
Official foreign liabilities (million baht)	+ 864	-15,026
Average export growth in previous two years (% RS)	4,878	20,924
Average import growth in previous two years (% RS)	37	22
Oil imports as a proportion of exports (%)	20	35
Budget Deficit (million baht)	17	29
	5,307	20,000

It is clear from Table 1 that the most noteworthy change in Thailand's economic outlook between 1973 and 1979 is the deterioration in its external position. By October 1979 Thailand's international reserves had fallen to US\$1315

THAILAND

CHART 1 : MONEY, OUTPUT, PRICES, AND TRADE

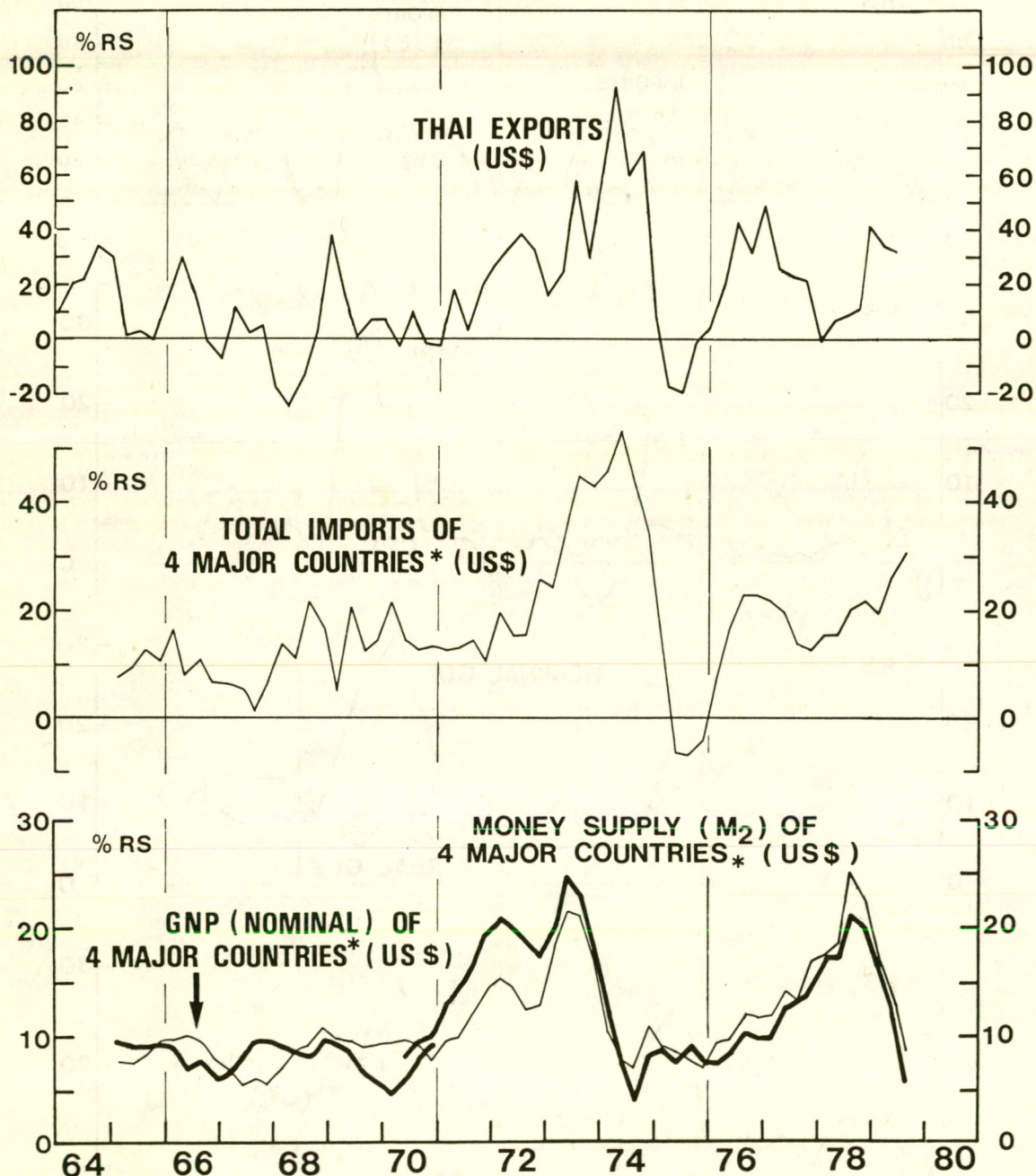


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THAILAND

CHART 2

DETERMINANTS OF THAI EXPORTS



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* US, UK, JAPAN, W. GERMANY

million, or 19% of total imports, from 40% of total imports at the end of 1973. The Thai government has acted to reduce this outflow in two ways:

- 1) Foreign borrowing. The ratio of external government debt and government-guaranteed debt to foreign reserves has risen dramatically from 42% at the end of 1973 to 195% in October 1979. Despite this, Thailand's official foreign debt remains relatively moderate in comparison with other developing economies, (at US\$1.9 bn., Thailand's official foreign debt is approximately a quarter of the level in the Philippines) and as a result Thailand is at present able to secure a ready supply of relatively cheaply priced loans. Nevertheless it is becoming crucial that the government acts to reduce substantially the level of domestic demand since in the absence of domestic policy changes the balance of payments deficit is officially projected to double during 1980 to 28 billion baht.
- 2) Revaluation of gold reserves. From the beginning of December 1978, Thailand's official gold holdings were revalued monthly on the basis of the London gold price at the end of each month. Although this does nothing to stem the outflow of international reserves it is a simple way of disguising their decline. Thus since November 1978 the official valuation of the monetary authorities' gold holdings increased from US\$106.8 million to US\$1008.3 million. In other words, without this revaluation Thailand's international reserves would currently be valued at US\$512 million, or a paltry 6.9% of annual imports.

Table 2

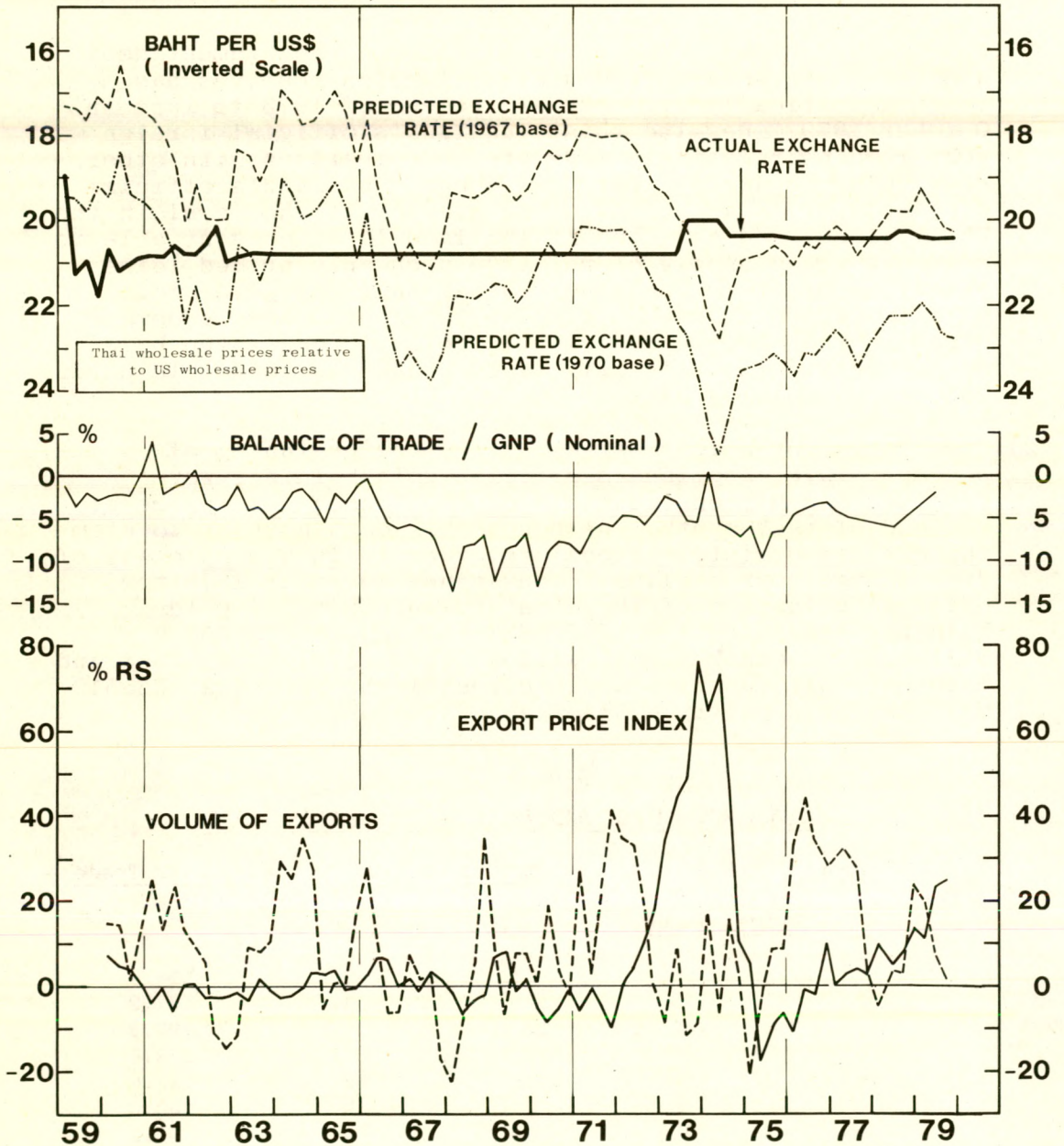
THE VOLUME, PRICE, AND VALUE OF THAILAND'S TRADE

	<u>Exports (% RS)</u>			<u>Imports (% RS)</u>			<u>Terms of Trade</u>
	<u>Vol.</u>	<u>Price</u>	<u>Value</u>	<u>Vol.</u>	<u>Price</u>	<u>Value</u>	
1970	6	- 5	0	3	1	4	114.4
71	30	-10	15	-15	18	- 1	87.2
72	19	9	31	16	0	15	96.3
73	- 7	54	44	24	10	36	133.6
74	12	37	54	- 7	64	53	112.4
75	- 4	- 6	- 9	- 2	6	4	100.0
76	38	- 3	35	3	5	9	92.2
77	15	2	17	20	7	28	87.6
78	8	7	16	7	8	16	87.8
79 (Aug)	3	26	29	24	25	53	88.5

An indication of some of the reasons for Thailand's dismal trade performance is found in Table 2. The outstanding characteristics of Thailand's trade record are the slump in its terms of trade since 1973, the weakening trend in the volume of exports since the end of 1975, and the relative insensitivity of the volume of imports to changes in their unit price. Thailand's propensity to import oil and oil-related products -

THAILAND

CHART 3 : TRADE, RELATIVE PRICES AND EXCHANGE RATE



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which comprise nearly 30% of total imports - is particularly worrying. Oil consumption grew at an average rate of 10% per annum from 1971 to 1978, and although this increase slowed to 2.9% during 1979, Thailand currently imports the same amount of oil as the Philippines despite the fact that Thailand has a smaller industrial base.* It is also worthwhile emphasising Thailand's relatively weak export performance during 1979 at a time when the Economist's index of commodity prices regained its 1974 level in real terms. The major part of the increase in commodity prices occurred in base and precious metals, so that while Thailand's tin and rubber exports benefited, they represent only 18% of total exports. The price of agricultural products (which represent nearly half of Thai exports) unfortunately remained relatively stable primarily because of a 15% fall in the export price of rice which is Thailand's largest single export.

Given Thailand's moderate export growth during a period when global monetary and trade conditions were at their most favourable, the outlook for the remainder of 1980 and 1981 is discouraging. Most major economies have pursued gradually tighter monetary policies since the end of 1978 and this will eventually lead to a world-wide weakening in aggregate demand. Chart 2 indicates that the sharp slowdown of the total money supply of 4 major countries (in US dollar terms) during 1979 is comparable to that in 1973. However, the implications for Thailand's exports are probably more drastic than after the earlier period since a portion of the slowdown is the result of the dramatic collapse of the yen against the US dollar. Japan is Thailand's largest export market - accounting for 20% of total exports - and the slowdown of the Japanese monetary aggregates in US dollar terms could have severe repercussions on the demand for Thai exports.

With the underlying trade accounts weakening and the country's reserve position having been temporarily boosted by the revaluation of gold, the longer term stability of the currency must be questioned. What is the likelihood of a Baht devaluation? To judge by Thai history it would appear to be rather unlikely. The country has after all successfully maintained a virtually unchanged pegged rate against the US\$ since 1955. To judge by the recent statistics, however, the possibility of some adjustment cannot be ruled out. Chart 3 shows two sets of predicted exchange rates calculated from relative price movements in Thailand and the United States. In general terms the direction of movement of the trade balance (and the overall balance of payments) has been correctly predicted by the degree of overvaluation or undervaluation of the currency. When the predicted Baht/US\$ rate is declining because the Thai inflation rate exceeds US inflation as in 1965-66 and 1972-74, the trade balance has subsequently deteriorated. Conversely when the predicted rate strengthens because of a higher rate of inflation in the USA as in 1963-64 and 1968-71 the trade balance has stabilised or improved.

* In 1978 29% of Thailand's GDP was derived from mining, manufacturing and construction compared with 39% in the Philippines.

It is notable that each of the two most serious periods of deterioration in the Thai trade balance - 1966-67 and 1974-75 as shown in Chart 3 - followed the two previous episodes of highly expansionary monetary growth. Increased monetary growth encouraged higher rates of growth of spending, and some of this spending showed up in higher rates of expenditure on imports.

Following this most recent third episode of monetary expansion and the accompanying deterioration in the trade and overall balance of payments, what is the downside risk in the currency? Using a purchasing power parity method of calculating the predicted exchange rate, the most pessimistic forecast (the 1970 base date) suggests a 12% devaluation would probably be sufficient to stabilise the currency. However it should be recalled that from November 1st, 1978 the authorities have brought in a new system for fixing the exchange rate on a daily basis vis-a-vis the US\$ "so as to reflect the supply and demand of foreign exchange in the Bangkok market". This gives the authorities a degree of flexibility should they be willing to let the Baht rate slide slowly over a period of time.

Domestic Sector

The Thai economy suffered a moderate monetary squeeze during 1979 as the year-on-year rate of growth of M_2 fell from 18.7% in January to 14.5% at the end of November. The rate of growth of M_1 declined from 20.5% to 14.2% over the same period. The tightness of the squeeze was reflected in a change in the composition of Thai commercial bank assets. In September 1978 investments in government bonds, treasury bills and private sector securities accounted for 14.6% of total assets while total loans, overdrafts and discounts accounted for 68.3%. As loan demand strengthened but the availability of funds tightened, investments declined to just 11.0% of total assets by September 1979 while loans, overdrafts and discounts rose to 71.4%. In the words of the Bank of Thailand's Department of Economic Research: "Signs indicating severe tightness in the money market induced the authorities to undertake remedial measures on many occasions, particularly from the second half of 1978 onwards when foreign interest rates began to accelerate upward."

The measures adopted by the authorities to try to prevent the slowdown in liquidity growth being reflected in higher interest rates included the following:

- a) Relaxation of the limits on commercial bank access to the Central Bank loan window. For example a 10 billion Baht "Crop Financing Window" was introduced to shield small farmers from the full impact of the credit squeeze.
- b) A Repurchase Market was set up for government bonds from April 9th 1979 effectively enabling commercial banks to convert long-term assets into short-term funds.

- c) The requirement that commercial banks hold government securities in specified amounts related to the number of branches they operated was relaxed so that government bonds that had been sold in the Repurchase Market could still be counted for this purpose.
- d) The 10% withholding tax on interest payments was suspended for foreign borrowings of commercial banks and other private enterprises.
- e) A change in the reserve requirements was devised which permitted commercial banks to include vault cash as reserves to meet the legal reserve requirement. Effectively this lowered reserve requirements.

Like many other economies which have begun to emerge from an era of controls Thailand's financial markets are hampered from functioning efficiently by the existence of numerous outdated laws. Although transactions involving one non-Thai resident were exempted, a 15% Usury Law distorted credit flows extensively. Either borrowers had to pay certain "fees" and maintain compensatory deposits against loans in order to raise the effective loan rate, or banks made loans to affiliated finance companies, simply diverting credit through other channels. In January this year the Thai government was forced to raise the loan interest rate ceiling to a more realistic 18%, but it remains true that the best policy would be to take things one stage further and abolish the lending rate ceiling altogether.

A measure of the degree of distortion produced by the imposition of interest rate ceilings in Thailand is suggested by the rapid growth of finance companies in Thailand in recent years. Aside from their advantage in being able to offer more flexible interest rates to depositors they also have the advantage that they do not have to maintain non-interest bearing deposits at the Central Bank. In the last five years their business has expanded rapidly to the point where they now have deposits equivalent to 20% of all deposits in Thailand. Following the collapse of Raja Finance Co. in early 1979 their growth slowed in the latter part of the year, but since they may currently offer up to 20% on deposits compared with 12% offered by the banks this slowdown will probably be temporary.

Accompanying the rise in the interest rate ceiling, the Bank of Thailand claimed that it would henceforth be willing to allow increased flexibility in deposit rates and in the price at which it discounts loans to the commercial banks. The increase in deposit rates from 8% to 12% was almost immediately successful in restoring banks' deposit base. The first two months of 1980 saw spectacular re-intermediation as banks' deposit liabilities increased by 7.5 billion baht or 4.5%. Despite this, the Thai monetary authorities are relatively weakly placed to accelerate or temporarily offset the effect of the balance of payments on domestic monetary policy. They rely on controlling the cost of credit through the Bank of

Thailand's discounting and repurchasing agreements with the banks, rather than regulating its availability. There are some minor selective credit controls on consumer purchases but in general the Bank of Thailand's policy is to make reserves available at a price and to reinforce a restrictive stance through moral suasion. That "price" in the long run will be whatever level of interest rates is necessary to keep the balance of payments in equilibrium. Persistently lower rates in Thailand than in the US will result in a steady drain on the balance of payments, and persistently higher rates will have the opposite effect.

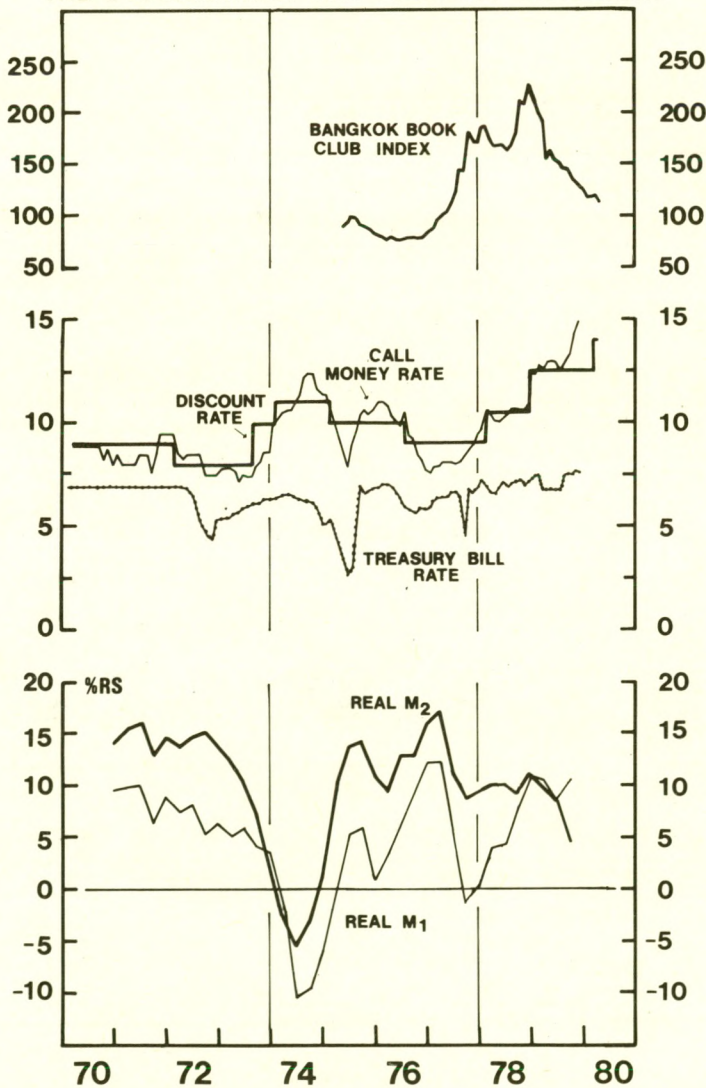
In order to hold interest rates down during 1978 and 1979 the Central Bank was obliged to create new funds, in excess of what was desirable for stability in the balance of payments. As a direct result the inflation rate in Thailand has doubled over the past year - accentuated admittedly by the partial relaxation of price controls (e.g. In June 1979 the Commerce Ministry's price control list was cut from 63 to 27 items and more recently the long-controlled domestic price of petrol has been raised.) Although the excess monetary growth achieved lower interest rates for a temporary period, the end result has been to produce higher rates. To curb the inflation the economy will now have to endure a tougher and longer squeeze than if the authorities had allowed interest rates to rise under natural market pressures in the first place. As this analysis suggests, the upward pressure on rates was produced by a strong and rising demand for funds clashing with a gradually decelerating money supply. Since the internal squeeze is still not so much a matter of deliberate policy as something that is being forced on the authorities by the weakness of the external balance of payments the immediate outlook must be considered somewhat ominous.

FORECAST: In the long run, by effectively pegging the baht to the US dollar the Thai authorities are committing their economy to experiencing similar rates of inflation to the US. Under pegged exchange rates the monetary authorities may temporarily accelerate or retard the speed of adjustment by interfering with domestic interest rates, just as the Thai authorities delayed interest rate rises in 1978-79. But ultimately they cannot usurp the fundamental economic adjustment mechanism whereby inflationary or deflationary pressures in the US are transmitted to the domestic economy through changes in the balance of payments position.

The choice that the Thai authorities now face is an uncomfortable one. Either the squeeze must be longer and harder than would previously have been necessary - this is the course presently being pursued by the Philippines. Or they can simply devalue, just as South Korea did in January, and this would soon allieviate the tightness of the squeeze being produced by the widening balance of payments deficit, but since it would also permit a higher average rate of money growth it would therefore simply produce a higher underlying rate of inflation over time.

It seems probable that the new administration under General Prem Tinsulanonda and his Deputy, Mr. Boonchu Rojanasthien from the Bangkok Bank, will choose to allow the external deficit to continue to drain reserves from the banking system and thus maintain the pressure in the money markets, at least until American interest rates fall significantly from their present levels. The Thai stock market which peaked in late December 1978 fell almost continuously through 1979 to stabilise below 120 in January-March 1980 may therefore not yet have seen its final trough. The economy itself will undoubtedly slow down during 1980 as a result of the lagged effects of the monetary squeeze, but the longer the economy takes to decelerate the more vulnerable the currency must be to the danger of devaluation.

CHART 4 : THAILAND
THE STOCKMARKET AND LIQUIDITY INDICATORS



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MONEY GROWTH RATES OF 11 ASIAN PACIFIC RIM ECONOMIES (Year-to - Year Percentage Changes)

COUNTRY	JAPAN	HONG KONG	SINGAPORE	MALAYSIA	AUSTRALIA	N. ZEALAND	S. KOREA	TAIWAN	PHILIPPINES	THAILAND	INDONESIA
DATE	M ₂	M ₂	M ₃	M ₃	M ₃	M ₂	M ₂	M ₂	M ₂	M ₂	M ₂
1975.											
Q1	10.7	15.8	15.9	15.5	11.9	2.3	24.1	29.9	14.5	18.0	36.5
Q2	11.6	17.5	17.3	13.8	14.2	5.4	27.6	33.8	18.1	17.7	36.5
Q3	13.3	18.8	18.8	13.4	21.4	9.4	25.6	32.3	16.5	18.2	41.7
Q4	14.5	16.9	18.8	14.4	21.2	12.0	27.9	29.4	19.0	15.5	37.9
1976.											
Q1	16.1	17.8	18.1	16.3	16.6	17.7	29.1e	25.9	20.5	16.3	41.6
Q2	15.8	15.3	17.8	20.0	14.2	20.3	30.3	20.8	23.8	16.5	33.3
Q3	15.3	17.6	17.6	25.6	12.7	17.5	26.5	19.0	26.8	17.6	30.3
Q4	14.6	20.4	18.1	27.9	12.2	18.0	32.6	22.4	23.9	19.6	33.6
1977.											
Q1	12.5	19.1	16.0	24.7	13.1	15.6	33.4e	25.2	26.6	20.0	27.9
Q2	11.4	20.8	15.6	23.4	11.0	13.1	34.2	30.4	24.2	20.6	33.2
Q3	11.4	19.7	12.9	20.3	8.2	13.4	39.8	31.6	20.8	20.8	27.0
Q4	10.6	19.9	10.6	17.5	6.4	12.5	40.8	33.1	23.0	19.8	21.4
1978.											
Jan	10.7	24.2	12.0	15.1	5.5	-	42.7	33.6	19.8	20.7	20.1
Feb	10.9	21.5	11.2	13.2	5.0	-	45.3	28.7	18.9	20.5	21.6
Mar	10.5	23.3	11.6	15.4	6.1	13.3	42.3	29.1	17.2	19.6	19.3
Apr	12.7	24.4	12.2	15.3	7.0	-	42.1	30.4	16.9	19.0	17.1
May	11.9	24.4	12.0	14.0	7.7	-	39.2	28.7	16.4	19.0	17.8
Jun	12.2	25.9	12.1	14.9	8.0	15.9	38.2	28.5	18.0	19.2	16.3
Jul	11.3	27.3	12.4	15.4	8.8	17.2	36.0	30.9	19.8	17.2	18.4
Aug	12.4	28.5	13.3	16.0	10.1	17.6	34.7	33.0	18.2	17.1	19.1
Sep	12.5	30.1	13.5	14.9	10.5	19.5	32.1	33.9	20.1	17.0	18.4
Oct	12.3	27.6	13.3	14.6	10.3	22.1	32.6	33.0	21.0	17.4	19.6
Nov	12.4	26.8	14.1	16.0	10.0	21.7	33.8	33.3	19.9	17.9	22.6
Dec	13.1	25.6	15.0	19.3	10.5	21.3	34.7	33.1	18.0	19.4	23.1

COUNTRY	JAPAN	HONG KONG	SINGAPORE	MALAYSIA	AUSTRALIA	N. ZEALAND	S. KOREA	TAIWAN	PHILIPPINES	THAILAND	INDONESIA
DATE	M ₂	M ₂	M ₃	M ₃	M ₃	M ₂	M ₂	M ₂	M ₂	M ₂	M ₂
1979. Jan	12.1	26.2	15.6	22.9	11.3	22.3	32.2	32.2	16.7	18.7	25.1e
Feb	12.1	24.6	14.3	22.5	11.6	22.4	28.5	26.8	16.4	16.9	25.1e
Mar	12.9	24.2	15.3	21.8	11.3	22.5	29.5	25.5	17.1	17.6	27.0
Apr	12.7	23.9	14.7	25.0	11.9	19.2	32.7	21.0	19.4	16.9	27.5
May	12.1*	22.3	15.1	25.9	11.8	20.3	27.2	20.0	17.0	16.5	29.6e
Jun	11.8	22.1	14.3	26.6	11.8	19.4	27.1	16.7	13.0	16.2	31.6
Jul	11.3	22.1	14.6	26.0	11.3	19.8	26.7	12.6	12.6	15.7	29.3
Aug	11.5	21.5	13.8	24.4	10.6	19.4	26.7	10.8	11.9	15.2	30.9
Sep	12.1	21.2	14.2	25.0	10.2	18.9	27.4	11.0	11.6	15.8	34.5
Oct	11.0	24.4	17.7	27.4	10.6	17.3	25.6	10.4	8.7	15.2	35.9
Nov	10.6	26.6	18.7	29.8	11.2	17.1	27.0	9.8	9.2	14.5	35.1
Dec	9.1	29.7**	20.4	27.7	11.6	18.8	27.4	9.5	10.7		
1980. Jan	10.1	32.2	20.9	28.0	12.7		24.2	6.0	11.1		
Feb		35.2			12.4			14.3			
Mar		31.9			11.7			13.6p			

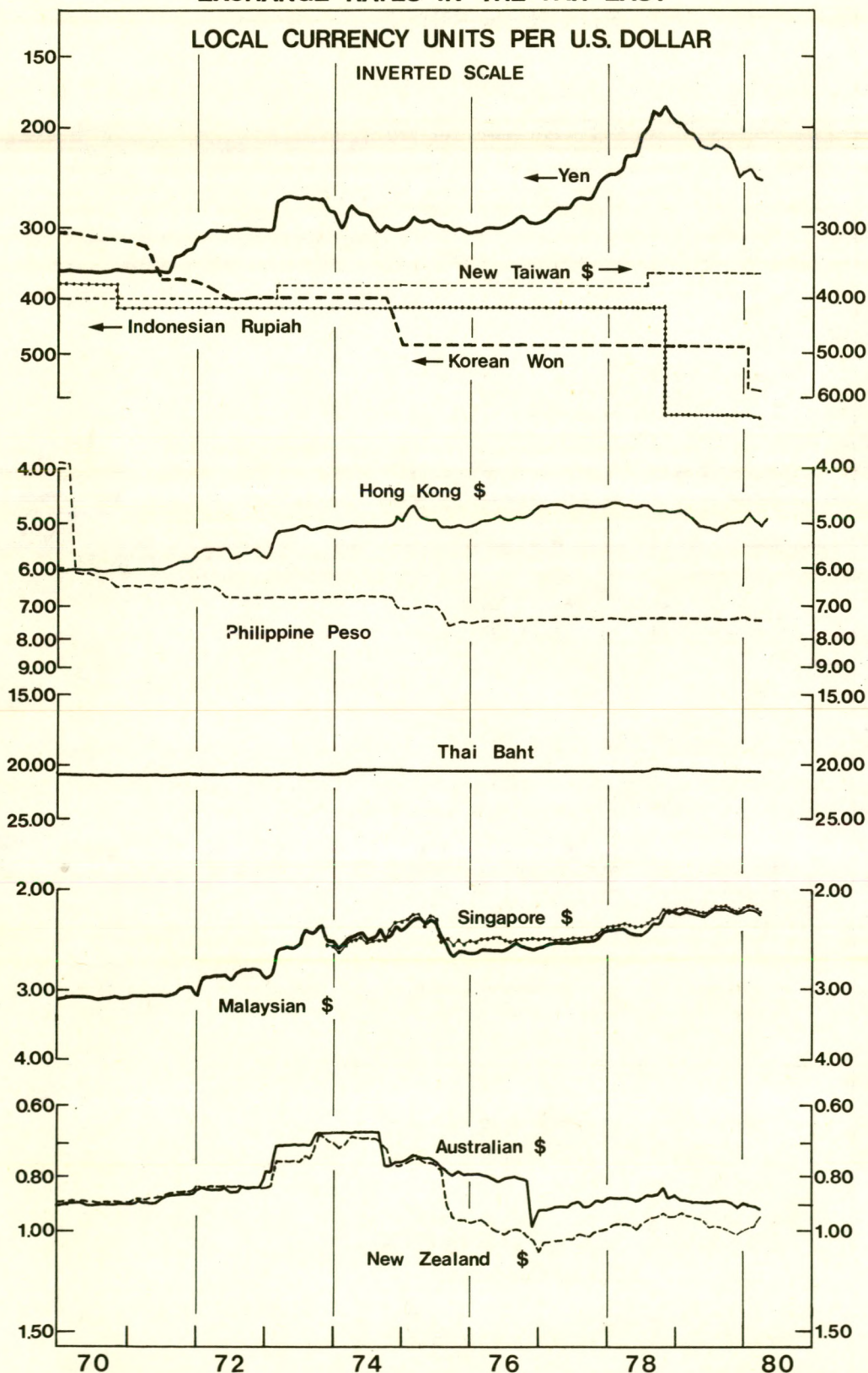
* From June 1979 onwards, M₂ + CDs.(e) : estimate
(p) : provisional** From Dec. 1979 onwards, M₃.

CONSUMER PRICE INCREASES IN 11 ASIAN PACIFIC RIM ECONOMIES
(Year-to-Year Percentage Changes)

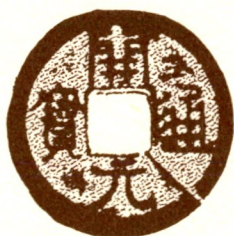
COUNTRY	JAPAN	HONG KONG	SINGAPORE	MALAYSIA	AUSTRALIA	N. ZEALAND	S. KOREA	TAIWAN	PHILIPPINES	THAILAND	INDONESIA
DATE											
1975. Q1	14.9	1.3	6.0	8.5	17.6	13.2	22.4	9.1	18.3	10.4	20.5
Q2	13.9	1.8	3.1	4.9	16.9	14.9	24.4	5.6	9.3	4.5	17.2
Q3	11.1	0.5	2.1	3.5	12.1	14.8	27.8	4.7	3.7	3.5	18.8
Q4	9.0	0.6	-0.7	1.5	14.0	15.6	30.2	2.1	2.3	3.4	19.6
1976. Q1	10.2	2.9	-1.3	1.2	13.4	17.1	23.4	3.3	4.0	5.2	21.0
Q2	9.3	3.5	-1.5	2.6	12.3	17.7	17.6	3.7	6.6	3.8	20.2
Q3	9.2	5.3	-2.8	3.1	13.9	17.2	13.7	2.0	5.9	3.6	21.5
Q4	9.4	3.8	-1.8	3.7	14.4	15.7	8.8	1.5	5.7	4.3	16.8
1977. Q1	9.3	6.6	0.5	4.4	13.6	13.7	10.5	3.2	7.5	3.5	12.9
Q2	8.9	5.6	1.8	4.2	13.5	14.0	9.6	5.1	6.7	7.2	12.3
Q3	8.7	4.9	5.1	5.0	13.1	14.4	10.1	10.2	7.8	9.5	9.4
Q4	6.2	5.0	5.5	5.6	9.3	15.3	10.7	8.5	9.7	8.5	9.7
1978. Jan	4.5	5.3	5.1	3.9	-	-	12.9	1.2	7.7	8.8	10.2
Feb	4.4	4.3	5.6	4.7	-	-	12.3	6.3	7.8	8.3	10.3
Mar	4.9	4.3	4.5	4.5	8.2	14.6	12.6	6.8	6.6	9.0	10.1
Apr	4.5	5.8	5.0	4.7	-	-	12.4	8.0	6.2	8.5	11.0
May	4.3	5.8	5.9	4.8	-	-	12.6	7.4	6.6	7.9	8.8
Jun	3.6	4.0	5.5	6.2	7.9	12.2	14.6	4.0	7.0	8.1	10.9
Jul	4.9	5.1	5.6	5.4	-	-	14.4	3.6	6.3	6.7	7.4
Aug	4.5	6.5	4.2	5.6	-	-	13.5	1.1	7.8	8.5	8.1
Sep	4.4	6.3	4.3	5.2	7.9	11.1	15.5	4.1	8.0	6.7	5.1
Oct	4.1	7.3	4.5	5.1	-	-	17.0	6.1	8.9	7.2	5.5
Nov	4.0	7.0	4.7	4.4	-	-	17.4	7.5	9.1	7.8	7.0
Dec	4.0	8.5	3.0	3.9	7.8	10.1	16.6	7.7	8.0	7.8	6.7

COUNTRY	JAPAN	HONG KONG	SINGAPORE	MALAYSIA	AUSTRALIA	N. ZEALAND	S. KOREA	TAIWAN	PHILIPPINES	THAILAND	INDONESIA
DATE											
1979.											
Jan	3.6	7.1	2.1	3.8	-	-	14.1	6.2	9.6	7.0	9.3
Feb	2.5	7.4	0.6	3.2	-	-	16.6	5.9	9.2	7.2	11.8
Mar	2.5	9.3	2.7	3.9	8.3	10.3	16.7	7.2	11.7	7.1	11.7
Apr	2.5	11.7	2.5	4.0	-	-	19.7	7.3	18.2	7.1	13.1
May	2.7	11.8	2.9	4.3	-	-	22.3	8.3	19.8	7.3	18.9
Jun	3.7	12.3	2.9	2.7	8.8	12.4	20.0	9.6	20.4	6.9	23.3
Jul	4.3	12.3	3.0	3.3	-	-	18.4	10.8	21.0	9.6	28.6
Aug	2.7	13.5	4.3	3.0	-	-	18.3	11.7	23.2	10.8	29.9
Sep	2.7	14.4	5.8	3.4	9.2	15.2	16.7	13.5	23.4	12.8	32.4
Oct	4.2	13.5	6.1	3.3	-	-	16.4	12.3	22.7	13.6	32.7
Nov	5.1	14.8	6.5	3.7	-	-	17.6	11.1	22.0	13.7	30.4
Dec	5.5	15.3	7.4	5.2	10.0	16.5	20.6	12.5	24.2	15.0	30.1
1980.											
Jan	6.2	16.0	7.4	6.4			24.0	16.4	23.8	17.9	28.3
Feb	7.7	19.2	9.3	6.4			24.4	18.4	-		27.2
Mar	7.3	17.9					26.5e	17.4	24.9		26.8
Apr	7.6p								19.7		

EXCHANGE RATES IN THE FAR EAST



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EDITORS:

John G. Greenwood

M.A. (Hons) Econ. Edinburgh
Research Economist, University of Tokyo
Economist at G.T. Management (Asia) Ltd.

Christian Wignall

B.A. Econ. Cambridge
Economist at G.T. Management (Asia) Ltd.

Hugh Sloane

B.A. Econ. Bristol
M. Phil. Econ. Oxford
Economist at G.T. Management (Asia) Ltd.

**CHARTS AND
STATISTICS:**

S.Y. Chan

Michael Wong

ADMINISTRATION:

Isabella L.Y. Ling

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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

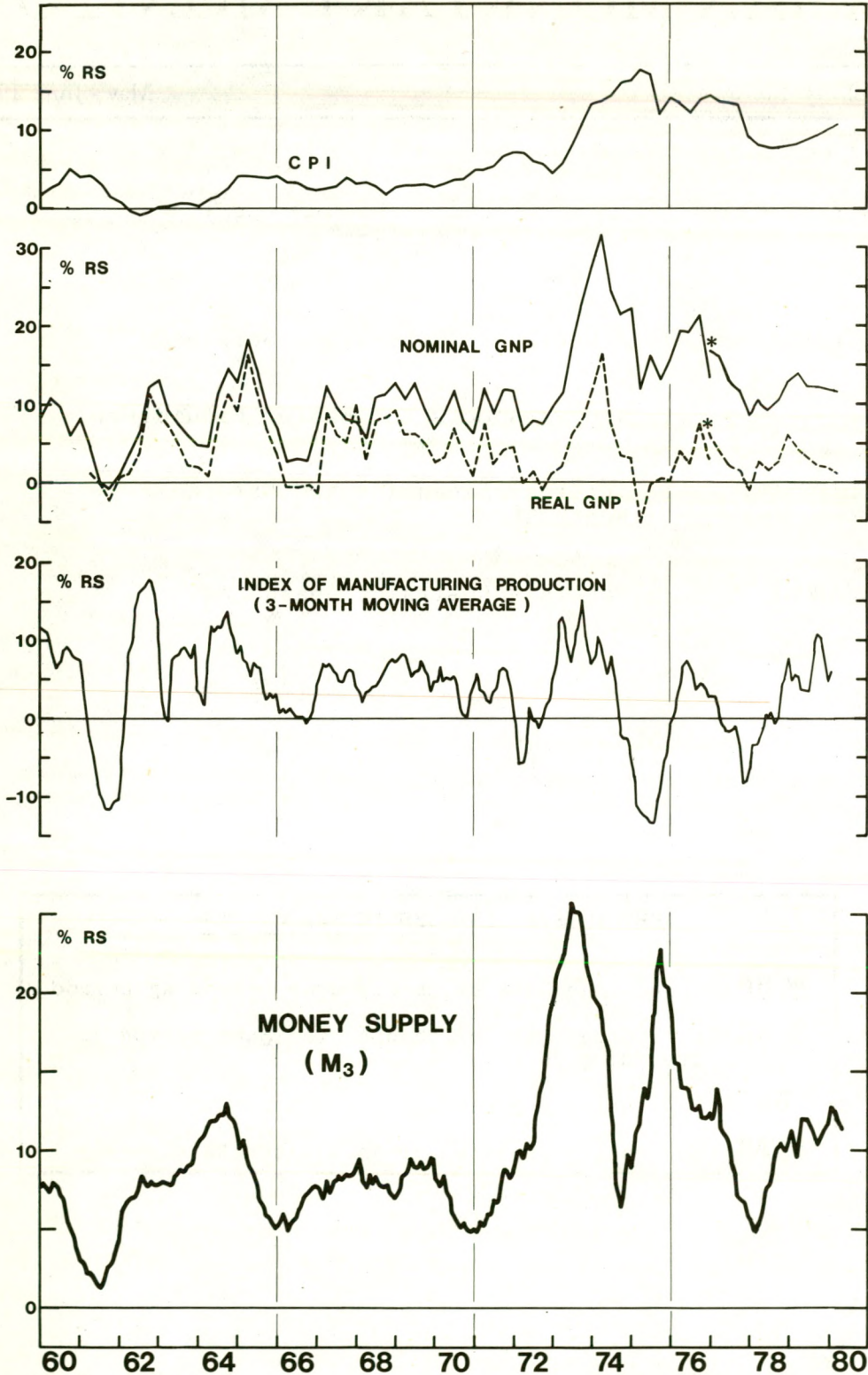
% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

AUSTRALIA

CHART 1 : MONEY, OUTPUT, AND PRICES



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AUSTRALIA

A DECLINE IN THE TRADE SURPLUS

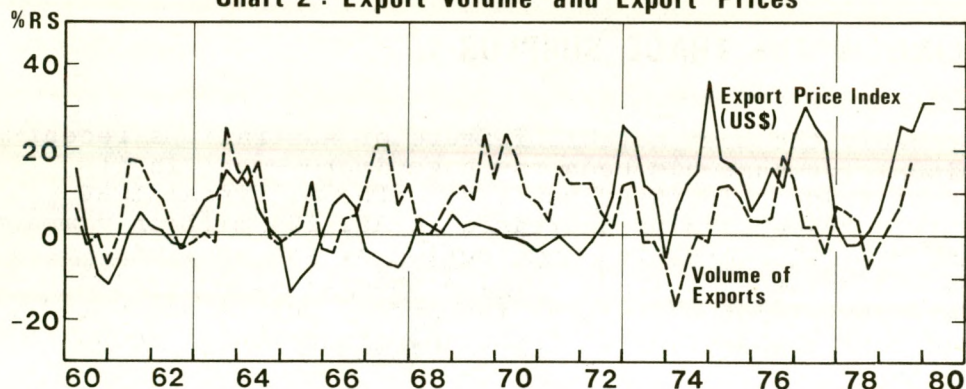
Probably the most notable feature of Australia's recent economic performance has been the huge improvement in its balance of trade. In the first ten months of fiscal 1980 Australia's trade surplus increased to A\$2,524 million compared with A\$273 million over the same period of the previous year. This record balance of trade surplus underlines Australia's fortunate possession of natural resources, but is undoubtedly also due to a combination of favourable fundamental economic circumstances.

The current strength of the Australian trade surplus is not, primarily, a reflection of windfall gains as a consequence of the steep rise in commodity and agricultural prices. The 24.2% rise in the export price index during 1979 was offset by a 29.8% surge in the unit price of imported goods and as a result Australia's terms of trade actually declined in the past eighteen months from 90.0 in December 1978 to around 87.0 in March 1980. In fact, the substantial improvement in the trade balance has been due to an increase in the growth of the volume of exports relative to the growth of the volume of imports. In the year ending in September 1978 the volume of imports had increased by 6.0% whereas export volumes had declined by 8.1%, resulting in a small trade deficit. A year later this position had been dramatically reversed with import volume falling by 2.7%, whilst the volume of exports rose 17.3%.

The question then arises as to whether or not the trade surplus may be sustained or if its current strength is primarily a consequence of favourable cyclical influences. We shall argue that the Australian trade balance is either at or near a cyclical peak. To simplify the analysis we shall assume initially that the trade weighted exchange rate and relative import and export prices adjust in such a way as to leave Australia's terms of trade at their present levels over the next year. Using this assumption the outlook for the trade balance would depend, therefore, on the relative rates of growth of import and export volumes.

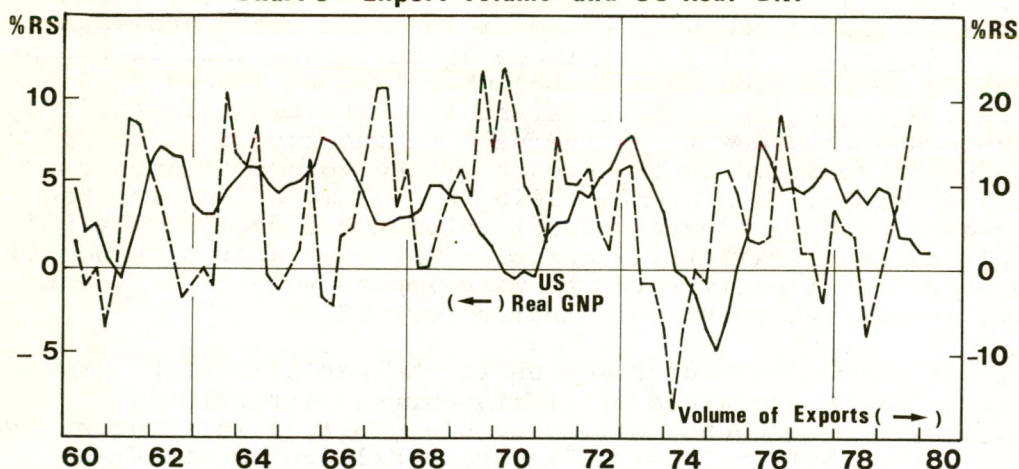
A glance at Chart 2 reveals that it is difficult to establish a close relationship between the volume of exports and their price in US dollar terms. In the periods from 1960 to 1964, 1972 to mid 1976, and again over the last eighteen months there is a strong positive correlation between prices and volumes. Ordinarily we would expect the demand for exports to fall as their price rises, but Chart 2 indicates that over significant periods in Australia's recent economic history, the level of export volumes has been determined predominantly from the supply side. In other words, an important factor in cyclical changes in export volumes appears to be the manner in which Australian exporters react to price incentives. Moreover, the fairly high price elasticities of supply implied

AUSTRALIA
Chart 2 : Export Volume and Export Prices



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AUSTRALIA
Chart 3 : Export Volume and US Real GNP

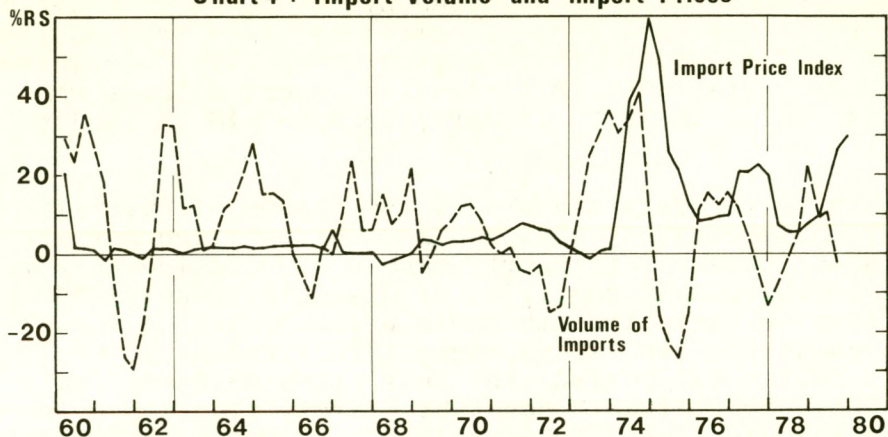


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by some of the periods illustrated in Chart 2 are not too surprising since only 30% of the value of Australian exports consists of food and live animals (the production of which is relatively insensitive to price in the short term) whilst 50% of exports is in manufactures, chemicals and metals where it is more feasible that production levels could be altered or stockpiled. However, we should beware of trying to forecast the volume of exports by looking solely at exporters' response to price changes since a) the picture on the supply side is complicated by weather considerations which are essentially random, and b) the expected relationship between export volumes and their overseas price is also an important influence with volume and price moving inversely during 1965, 1966 and 1967, and again in 1977 and 1978.

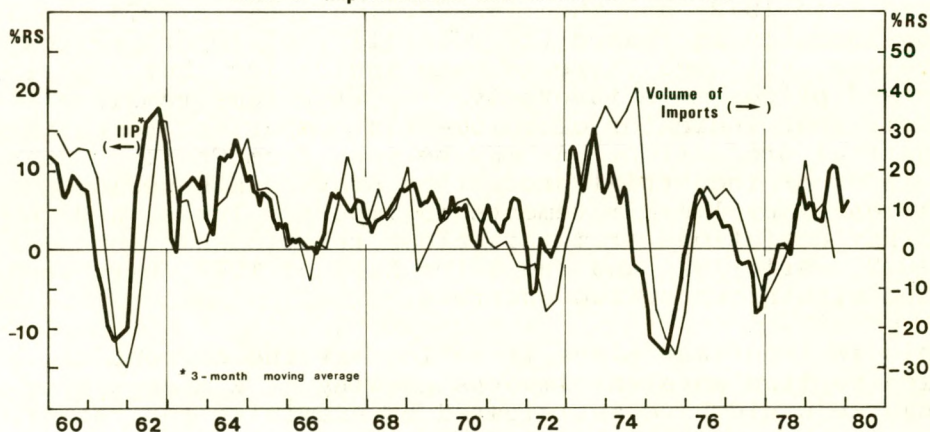
In considering the likely outlook for the volume of Australian exports an important point to note is the US recession does not, in itself, provide a strong reason for expecting the rate of growth of physical exports to wane in the

AUSTRALIA
Chart 4 : Import Volume and Import Prices



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AUSTRALIA
Chart 5: Import Volume and Industrial Production



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coming year. Chart 3 indicates that there is considerable independence between the rate of change in the level of economic activity in the US and Australia's export volume. In many respects this is not surprising since the US market accounted for only 11.9% of total Australian exports in 1979 compared with Japan's 33.7%, the EEC's 11.1% and ASEAN's 7.3%. Nevertheless, with the rate of increase in aggregate demand in many of Australia's trading partners being reduced by tight monetary policies, it is likely that the demand for Australian exports will contract. The combined rates of growth of the money supply (in Australian dollar terms) of four of the world's major economies* has dipped sharply over the past three quarters from a year-on-year increase of 21% in June 1979 to 5% in March 1980. This is an indication of the extent of the decline in purchasing power for Australian exports and we expect this to result in a slowdown in volume growth in the

* The US, UK, W. Germany, Japan.

same way that occurred during the last recession. In 1973, foreign purchasing power as measured by the combined monetary growth rates of the same four economies declined from 13.1% at the end of 1972 to -5.0% at the beginning of 1974, presaging a very severe curtailment in Australian export volumes whose growth rate fell from 13.2% in April 1973 to -16.5% in June 1974.

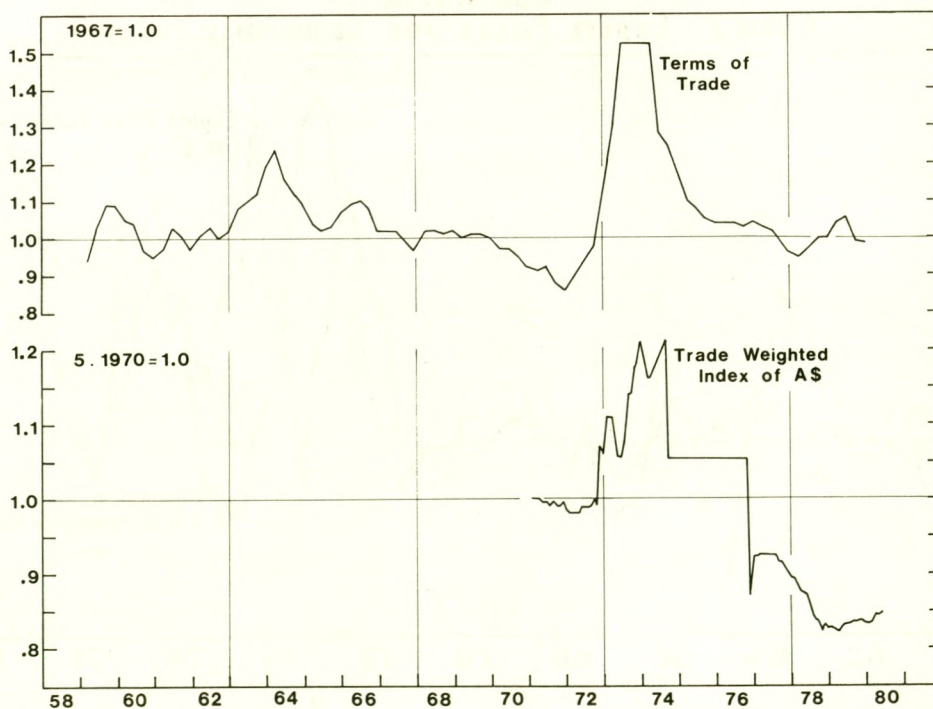
Turning to the determinants of the volume of Australia's imports it is immediately obvious from Charts 4 and 5 that changes in the demand for import volumes are considerably more sensitive to changes in the level of domestic industrial activity than to variations in their price. Chart 4 shows that throughout the 1960's and early 1970's whilst the Australian dollar was pegged, the unit price of Australia's imports remained remarkably constant, rarely changing by more than 5% in any one year. Nevertheless, the volume of imports exhibited considerable volatility which, to all intents and purposes, was entirely independent of changes in their price. The move to a floating exchange rate system by many of Australia's trading partners, the revaluation of the Australian dollar in late 1972, and then two devaluations in 1974 and 1976 have considerably increased the volatility of import prices. Nevertheless, although there is some indication that import volumes and prices move inversely, import prices remain a relatively poor indicator of volumes in comparison to changes in industrial production. As may be seen from Chart 5, changes in the index of industrial production provide a superior explanation of cyclical movements in import volumes, and in general any deviations from this close relationship, such as in 1969, 1972, early 1974 and the later half of 1979, have been rectified within one or two quarters.

This is important since if we look at the current situation we find physical imports growing at a much slower rate than we would have anticipated by examining the recent increase in the index of industrial output. Industrial output increases are typically presaged by rises in domestic liquidity (see Chart 1). Since the rate of growth in the money supply, albeit fairly moderate, shows no signs of abating it is likely that industrial output will continue to expand at around its present rate. This should underpin Australia's real economic growth rate and increase the demand for imports, thereby reestablishing the historically close relationship between import volumes and output. The major caveat to this forecast lies with the possibility that the import unit prices continue to rise at a strong pace. Although industrial production is a superior coincident indicator of import volumes it is nevertheless clear from a comparison of Charts 4 and 5 that the rises in import volumes in 1976 and again in late 1978 were accompanied by slower rates of price increases. However, on balance it seems likely that inflation rates in the majority of Australia's trading partners are likely to slow during 1980, and clearly the impact of this on import prices would be reinforced by any further appreciation of the Australian dollar's trade weighted value. It is therefore likely that import volumes will rise providing money supply growth remains moderately buoyant.

Thus if Australia's terms of trade remain constant we should expect that the trade surplus will be reduced. With the onset of the US recession and with contractionary monetary policies producing a slowdown in economic activity in many of the major developed economies it is very likely that global inflation will fall in the coming year, and hence there will be a tendency for the rate of growth in both import and export prices to decline in Australia over the medium term. In attempting to forecast Australia's terms of trade, however, the important question is whether the price of finished goods (which form the majority of Australia's imports) decline at a faster or slower rate than the price of primary products (which constitute 70% of Australian exports). Some indication of the answer to this question may be found in Charts 2 and 4. It is clear that over the past two decades there is evidence of a secular tendency for import prices to rise at a faster rate than export prices. The secular decline in the terms of trade which this implies has only been interrupted in a significant way in 1972 and early 1973 when a large increase in unit export prices coupled with a 7.05% revaluation against the US dollar in December 1972 and further 11.1% appreciation two months later, created a 76.7% surge in Australia's terms of trade. (See Chart 6.) In other words the long term trend tends to suggest that Australia's terms of trade will weaken further in the coming year, adding downward pressure to the trade balance.

Moreover, cyclical influences seem likely to reinforce this conclusion. Although the current strength in the trade account is not merely a reflection of the recent boom in

AUSTRALIA : CHART 6
Terms of Trade and Trade Weighted Value of A\$



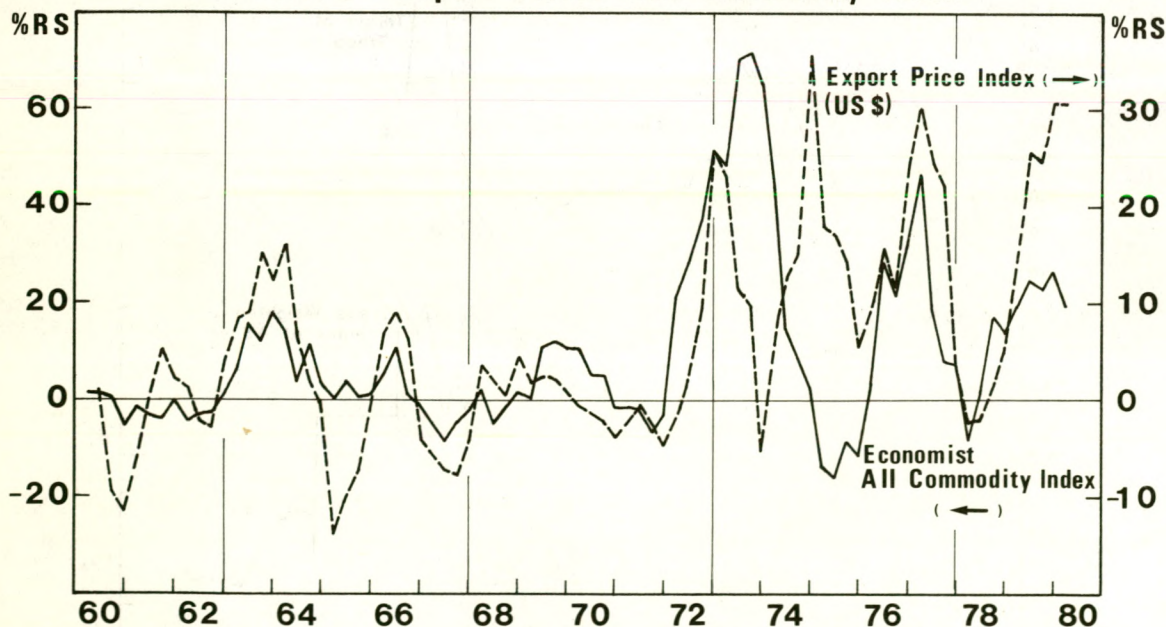
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commodity prices, Australian exporters nevertheless benefited substantially from a rise in the price in their products: Meat and sugar prices rose by 34.5% and 20.5% respectively 1979, whilst non-ferrous metal and petroleum product prices increased by 77.7% and 60.0%. Although the price of coal (whose export price increased a meagre 1.7% in 1979), and petroleum products, seem likely to rise further during 1980, and whilst some companies may have negotiated long term pricing contracts at favourable rates, the lesson from previous business cycles is that Australia's export prices are likely to fall fairly swiftly during the coming year. Chart 7 shows that there is a close relationship between the unit price of Australian exports in US dollar terms and the Economist's all commodities index. The only period in which this relationship goes awry is during 1973 and 1974. This is almost certainly explained by the 14.2% appreciation of the trade weighted index in 1973 and its subsequent 12.4% depreciation at the end of 1974. This is because the impact of a revaluation is to reduce the value of Australian dollar receipts in US dollar terms, whilst a devaluation produces the opposite effect. With primary product prices set to fall sharply as the US recession develops, and with world inflation falling only moderately in the medium term it seems probable that there will be downward pressure on Australia's terms of trade, just as there was during the last recession in 1974-75.

Essentially, from the point of view of its trade account, Australia is not particularly well placed given the current global economic outlook. It is faced with a situation where

AUSTRALIA

Chart 7 : Export Prices and Commodity Index



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the demand for its exports is likely to fall as a consequence of strict monetary policies overseas and where, in particular, the decline in commodity prices will probably have a severe impact on unit export prices. On the import side, Australia has not reduced domestic demand and there is little or no prospect of a domestically induced recession. Thus, on a fundamental view we feel there is little chance of the current absolute reduction in import volumes being sustained. Moreover, import prices will probably decline more gradually as wholesale price inflation recedes in Australia's trading partners. On balance, therefore, we feel the Australian trade surplus will decline during the remainder of 1980.

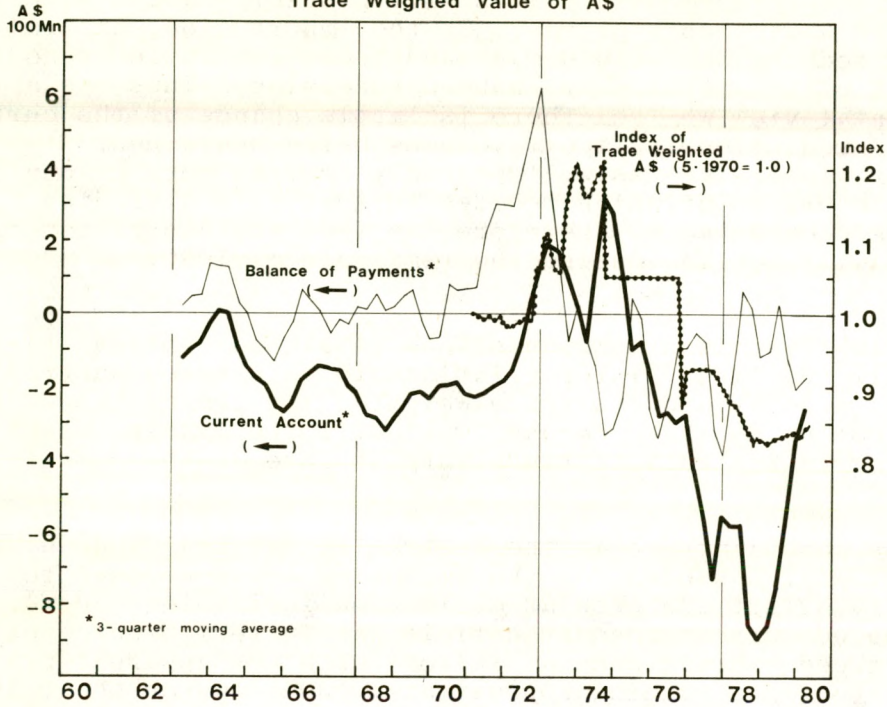
CONCLUSION: At least two questions remain unresolved: First, what will the likely inter-relationship be between Australia's external account and its trade weighted foreign exchange index in the coming months? Second, what will the likely impact of a decline in Australia's trade surplus have on the domestic economy?

The general trend in the Australian external account over the past year has been for the improving trade account to partially offset the secular deficit on invisibles. However, the reduced current account deficit has in term been counteracted by a reduced capital account inflow, with net apparent private capital receipts running approximately 30% down on their 1978 level, and substantial repayments of official loans creating a slightly increased overall payments deficit. Nevertheless, despite the enlarged balance of payments deficit the Australian dollar's trade weighted index appreciated slightly during 1979 and the first quarter of 1980 in the wake of the favourable trend in the current account (see Chart 8). There have been many claims by participants and observers in Australian financial markets that the Australian dollar is under-valued and hence that this appreciation in the trade weighted index is likely to continue. The increase in private capital flows during May 1980, the overall balance of payments surplus of A\$470 million in the first five months of 1980 (compared with a surplus of A\$151 in the first five months of 1979), and the prospect of very large capital inflows during 1981 to finance Australia's natural resource boom are certain to encourage these assertions. However, if we anticipate the trade surplus declines during the coming year then, with no improvement in the invisibles deficit in sight, the consequent increase in the current account deficit will mollify some of the pressures for an appreciation of the Australian dollar. Basically, we feel it would be unwise for the Reserve Bank to allow any appreciable rise in the Australian dollar's trade weighted index during a period when world economic activity is slowing down and when Australia itself is growing moderately strongly. A smaller, more gradual appreciation is a much more likely possibility, giving the Reserve Bank the opportunity to evaluate any new trends in the trade and capital accounts.

Turning to the impact of any reduction in the trade surplus on the domestic economy, it appears very improbable

AUSTRALIA: CHART 8

Current Account, Balance of Payments and
Trade Weighted Value of A\$

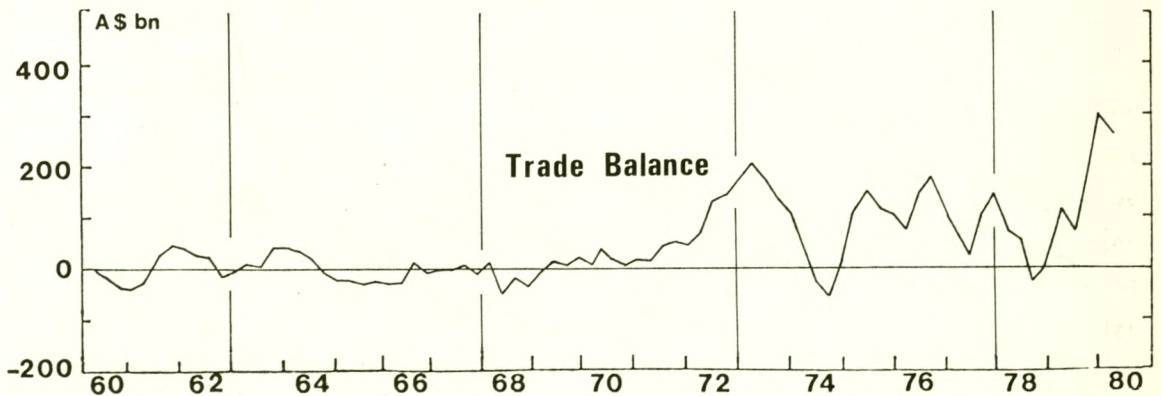
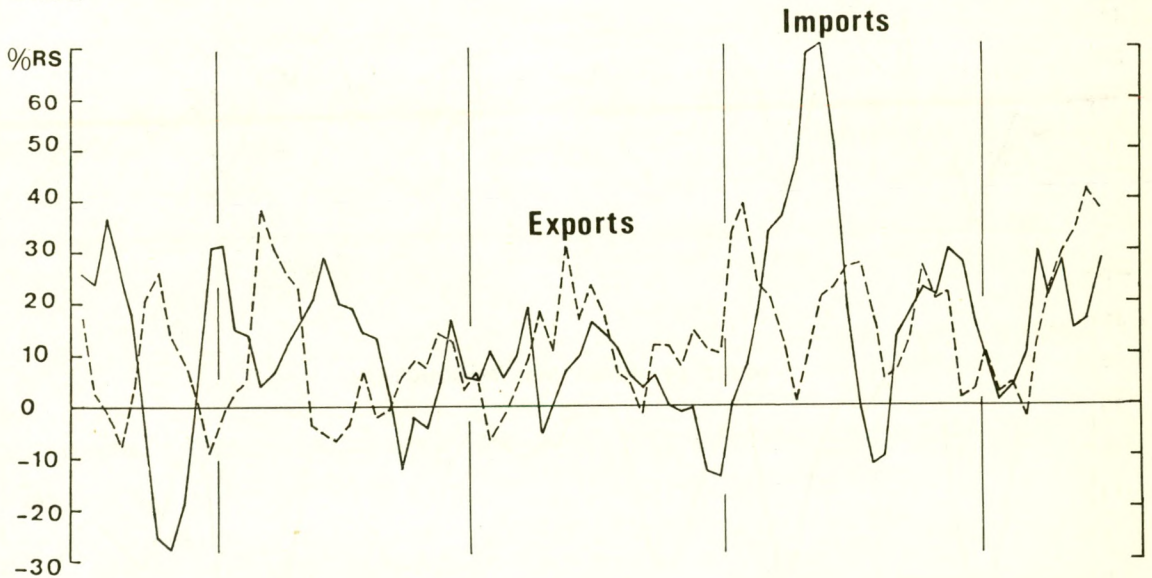
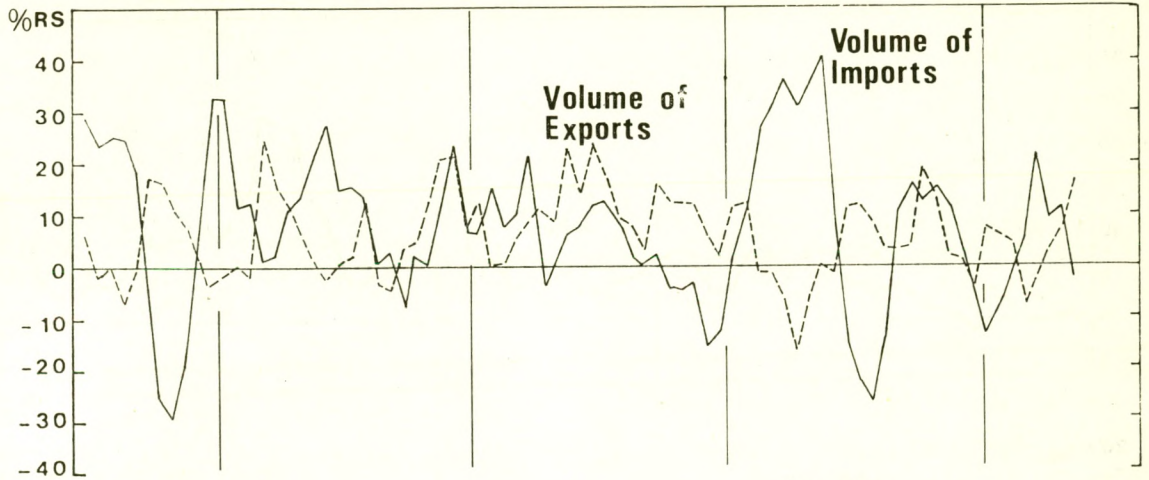


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that the Australian authorities will be forced to squeeze in order to offset a drain on the external account as occurred in 1974 and again in 1977 and 1978 (refer to Charts 1 and 8). We believe that any reduction in the trade surplus will be due primarily to declining overseas demand rather than Australian uncompetitiveness. Thus any setback in the trade account is unlikely to be as severe as in 1974, and any drain on the current account will probably be relatively mild. With Australian interest rates now exceeding those available in the United States, any increase in the current account deficit is unlikely to create much weakness in the balance of payments of the kind that presaged the domestic recessions in 1975 and 1978. In spite of the prospect of a deteriorating trade account during the latter half of 1980 it appears that Australia is in little danger of a recession in the medium term.

AUSTRALIA

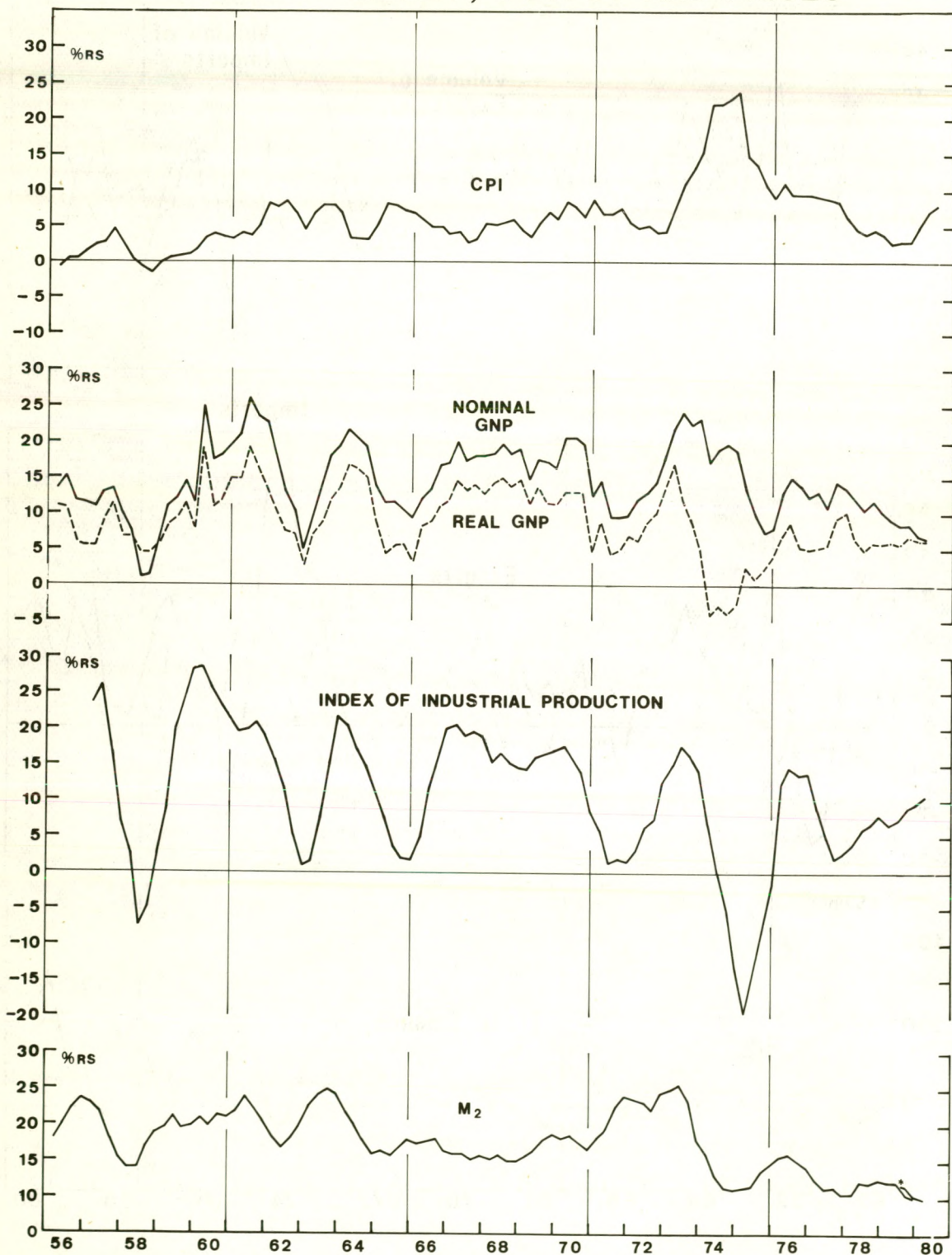
Chart 9 : The Trade Account



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JAPAN

CHART 1 : MONEY, OUTPUT AND PRICES



*Change in data series to M₂ + CD's

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JAPAN

THE PROSPECTS FOR EASIER LIQUIDITY

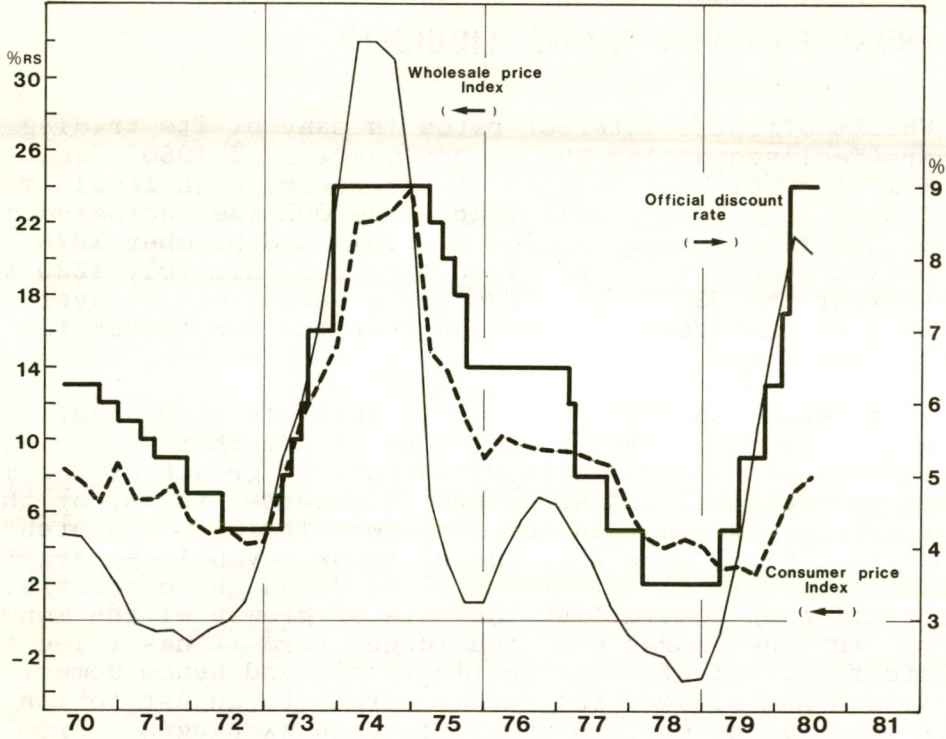
Whilst official interest rates in many of its trading partners declined during the second quarter of 1980, Japan's Official Discount Rate remains at the record high level of 9% established in February this year. The ODR was increased in five stages from a cyclical low of 3.5% in September 1978 in a period when the yen declined from approximately ¥220 to ¥260 against the US dollar. The yen's subsequent recovery has done much to encourage speculation that the ODR is due for an imminent reduction.

In a sense, such speculation is entirely misplaced. We have argued in many previous editions of AMM that any country's central bank can control either the rate of growth of the money supply, or the level and structure of interest rates, or the exchange rate, but that in the long term it is inconsistent to attempt to control more than one of these key policy targets. In broad terms, since 1974 the Bank of Japan has concentrated its attention on controlling the rate of growth of the money supply. In other words over the longer term it has tried to regulate the level of domestic liquidity, and hence domestic demand, and has allowed the exchange rate to adjust to its market level as determined on the foreign exchanges. From time to time of course, the Bank of Japan has intervened in the foreign exchange markets, the most recent occasion being the yen support measures in March of this year, in an attempt to ameliorate speculative pressures on the currency but here two points should be noted. First, whenever - as for example in March of this year - the Bank of Japan has bought yen in order to prevent the yen/dollar rate falling, it has simultaneously increased the quantity of yen it lends to the domestic banking system. In other words, the decrease in the monetary base which would otherwise have occurred as a result of the Bank of Japan's yen support operations is offset by an increase in domestic liquidity formation. Second, the Bank of Japan's operations have invariably only been temporarily successful, thereby providing additional support for the hypothesis that in the longer term it is impossible to peg a currency at a rate which is incompatible with the level of domestic demand and prices.

Thus although the rise in the ODR was coincident with the depreciation in the yen it is not the case that the increase in the ODR was of a defensive nature: The Bank of Japan instigates changes in the ODR in order to achieve the domestic objective of combating inflationary pressure. It does not alter the ODR in an effort to meet specific targets for the exchange rate. Therefore, the yen's strength against all major currencies in recent months is not in itself a reason to expect the ODR to be reduced.

JAPAN

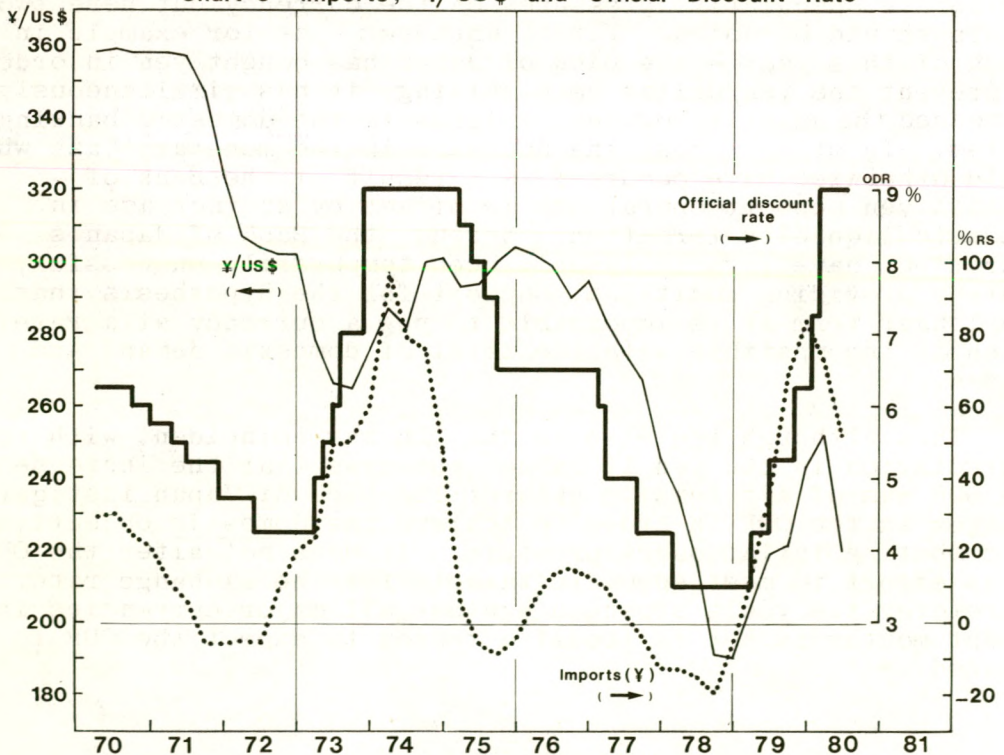
Chart 2 : Official Discount Rate and Inflation



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JAPAN

Chart 3 : Imports, ¥/US\$ and Official Discount Rate



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However, this is not to say either that adjustments in the ODR have no impact on the exchange rate, or that the outlook for inflation, and by inference the ODR, is independent of the external value of the yen. A comparison of Charts 2 and 3 shows the trends in Japanese consumer and wholesale price inflation, and in the exchange rate in recent years. A theoretical explanation for the observed changes since the last recession could be constructed along the following lines. The tight liquidity policies followed by the Bank of Japan (refer to Chart 1) during 1974 and 1975 produced sharp, lagged, reductions in both input and finished good prices. Unlike other countries, Japan continued to maintain a tight rein on monetary expansion during 1976, 1977 and 1978. As a consequence consumer price inflation in Japan fell below that in many of its major trading partners and the improved competitiveness of Japanese exporters coupled with a restrained demand for imports led to a sustained improvement in Japan's external position.

The growing trade surplus combined with investors' confidence in a low inflation currency created sizeable cyclical strength in the yen. The appreciation of the yen naturally led to a reduction in import prices in yen terms. Since the majority of Japanese imports are producer and primary products the wholesale price index benefited accordingly and actually declined in absolute terms from the fourth quarter of 1977 to the second quarter of 1979. This reduction in input prices created an easing in corporate liquidity and further downward pressure on interest rates. From a plateau of 6.25% in April 1977, the ODR fell to 3.5% in March 1978 as the yen strengthened and the rate of increase in input prices declined. The strength of the yen created a dramatic turnaround in Japan's trade surplus and the yen subsequently weakened throughout 1979 and the first quarter of 1980. This reinforced the increase in wholesale prices that would in any case have occurred following the rise in oil and other commodity prices. Throughout this period Japan's money supply grew at a very stable rate, only decelerating slightly from 12% at the beginning of 1979 to 10% in June 1980. However, although the mild reduction in the money supply indicates that there has been no domestically-induced upward pressure on consumer price inflation, the increase in input prices as a result of the yen's weakness led to a lagged increase in the price of finished goods. With money supply growth slowing down, with inflation rising, and with the real economy still growing strongly, Japanese liquidity was effectively tightened, thereby precipitating increases in the ODR.

In recent years movements in the Japanese wholesale price index have proved to be a reasonably accurate leading indicator of changes in the ODR. Nevertheless we would not want to place undue emphasis on the recent downturn in wholesale price increases as a signal that the ODR is due for an imminent reduction. One reason for this is the variable lag between peaks and troughs in the rate of increase in wholesale prices and changes in the ODR. A second reason is that the wholesale price index is not the only variable guiding the Bank of Japan in its

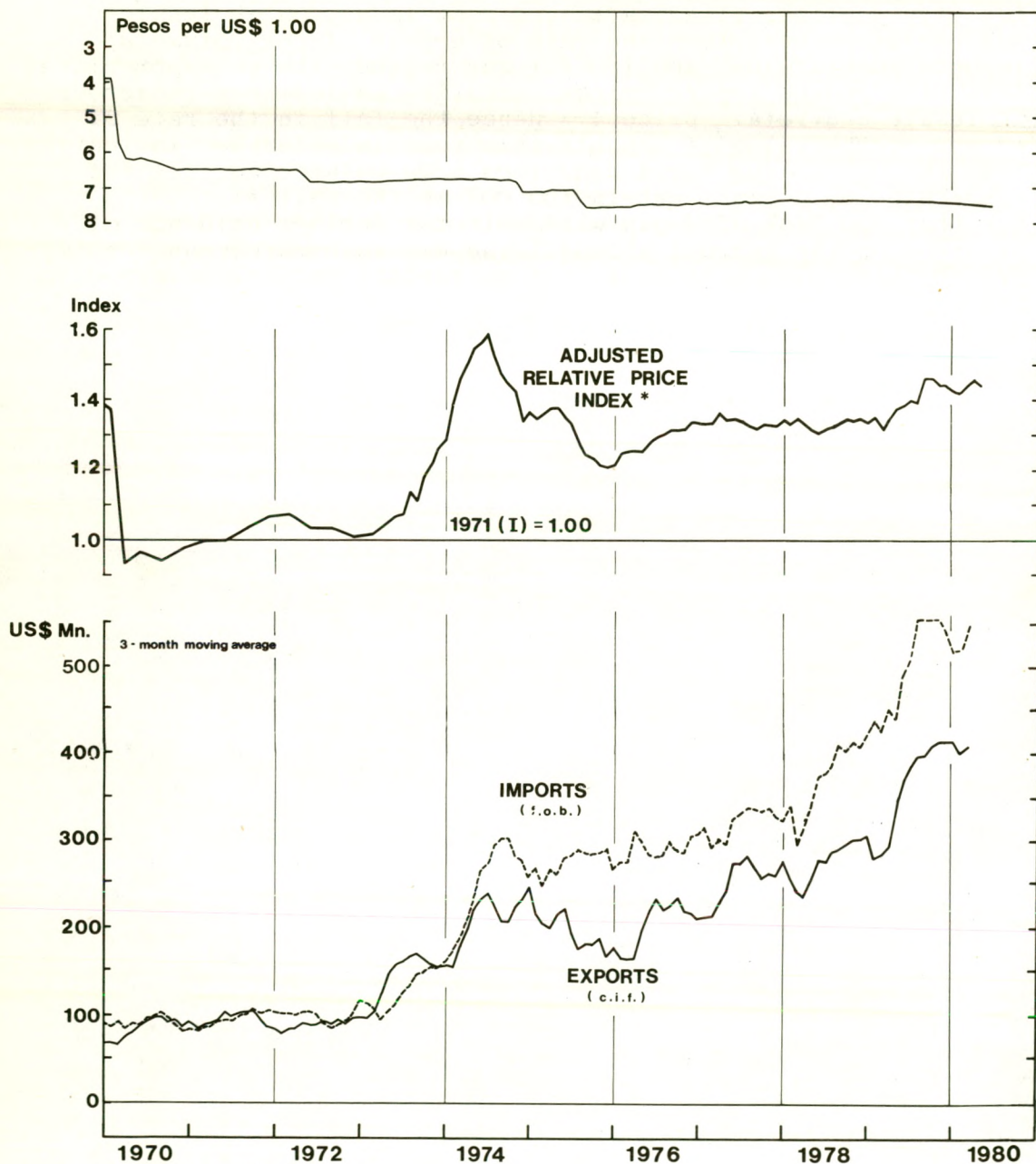
interest rate decisions. In this cycle conditions in the Japanese economy, despite some superficial similarities, are actually very different from the circumstances surrounding the reductions in the ODR in 1975. Two of the apparent similarities are that interest rates in the rest of the world are falling whilst Japanese official rates remain high, and that the yen has strengthened against the US dollar and other major currencies. However, given the current strength of the real economy the substantive difference between this cycle and the last one is that we cannot expect any significant easing in domestic liquidity as a consequence of a deep recession as occurred last time round. In 1974 the ODR was only reduced once there were clear indications that the year-on-year rise in consumer prices was falling, and this in turn occurred after the severe slowdown in the money supply and economic activity.

The important question to ask oneself in assessing the outlook for the ODR is whether a slowdown in the real economy is necessary to produce the easier liquidity conditions required for a sustainable reduction in the ODR, or whether the recent improvement in the Japanese current account, and the rise in the yen, will in themselves be sufficient to ease liquidity through a cyclical downturn in wholesale and (subsequently) consumer prices whilst allowing the economy to continue to expand at present rates. If one believes that a slowdown in real economic activity is a necessary precondition for a fall in inflation and interest rates then clearly recent money supply growth and the high level of industrial production indicate that the scene has yet to be set for a decline in the ODR. However, it may be that the circumstances presaging a cut in the ODR in this business cycle are entirely different from those in previous years. If the yen continues to trade close to its present level (i.e. around ¥220) against the US dollar this will reinforce the downward pressure on import and wholesale prices that will follow from the decline in oil and other commodity prices. Growth in the consumer price index will then begin to level off providing the Bank of Japan sticks to its current relatively tight monetary policy. Therefore, providing there is no further increase in the rate of growth of economic activity (which is relatively unlikely given the Bank of Japan's monetary stance), the implication of the yen's appreciation over the last three months is that we could expect an easing in liquidity sufficient to allow a reduction in the ODR. In other words, unlike during 1974 and 1975 when a tight monetary stance was reversed as a result of a dramatic decline in the volume of economic activity leading to a fall in prices, in this cycle liquidity will ease as a consequence of an adjustment in relative prices due to the rise in the yen.

FORECAST: A useful summary indicator of the combined impact of the volume of real economic activity in Japan and of relative prices is the rate of change of imports in yen terms. If the real economy is growing more strongly than its trading partners we would initially expect this to show up in a rise in the volume of Japanese imports, and subsequently reinforced by a weakening exchange rate. It follows that a change in

import values in yen terms should be a leading indicator of the easiness or otherwise of Japanese liquidity. If economic activity declines (leading to a direct impact on wholesale and retail prices) then the rate of growth of the volume of imports should slow, and if, for any reason, the yen appreciates this will reduce import prices (creating an indirect impact on wholesale and retail prices). Hence the fall in the rate of growth of the value of imports this year is a further indication that the ODR is due for a reduction. On balance we feel that there will be a small cut in the ODR in the next two months but that the Bank of Japan will wait for further evidence of progress on the current account, the exchange rate, and consumer prices, before committing itself to further reductions after that.

PHILIPPINES
CHART 1 : EXTERNAL TRADE, RELATIVE PRICES AND EXCHANGE RATE



* Philippine prices vs. U.S. prices adjusted for exchange rate changes.

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PHILIPPINES

INTERNAL EXPANSION AND EXTERNAL WEAKNESS

In the past twenty years the Philippines has only achieved a balance of trade surplus twice - in 1963 and 1973. The first trade surplus came in the year following the 49% devaluation of 1962. The second trade surplus accompanied the world-wide commodity boom of 1973, but was wiped out in the next year as oil prices rose and the Philippines found its import bill rising faster than its export receipts.

However, it should always be remembered that a balance of trade deficit is normal for a developing country. The typical pattern is for a developing country to run a trade (and current account) deficit which is offset by a capital surplus or "inflow". Assuming the exchange rate to be pegged (as it generally has been in the Philippines), an "outflow" due to an excess of imports over exports will be matched by an "inflow" of capital and other invisibles. In developed countries one would generally expect the opposite pattern to be the case: trade (and sometimes current account) surpluses to be matched by capital "outflows". Developing countries which are typically short of capital ought to be able to attract capital from foreign businesses, private individuals, foreign governments and international agencies by the high rates of return available. What assurance is there that the "outflow" on trade or current account will be counterbalanced by a sufficient capital "inflow"?

In reality there is no such thing as an "inflow" or an "outflow". Foreign currency generally does not circulate inside another domestic economy. When capital "flows in" or "flows out" foreign currency must be exchanged for local currency, so that the end result is simply a transfer of the ownership of funds (or property). Foreigners, who believe that the returns on capital in that country are higher than those available elsewhere, bid down the high cost of capital by offering it for loan or equity purposes, while residents of the developing country obtain the necessary foreign exchange to buy foreign-made consumption goods or services or capital equipment.

So long as the exchange rate is pegged at a particular rate by the authorities, all the "inflows" must match all the "outflows", otherwise the price of the currency would be bid up or down. The role of the central bank or the authorities in a fixed-exchange rate regime is therefore to act as a residual buyer or seller in the currency markets, so that one ought to be able to track whether a central bank is being successful or not in maintaining the pegged rate by following the changes in exchange reserves. This is easy enough where movements in the foreign exchange reserves are large and where exchange rates and accounting systems remain unchanged. The difficulties start when the accounting methods of a central bank change, and they are amplified when movements in exchange rates are translated into changes in the amount of foreign exchange reserves.

In the case of the Philippines these apparently theoretical questions have real substance. The country has made no progress in recent years in eliminating its trade deficit (see Chart 1), so that it has had to attract a steady inflow of capital. In the light of the discussion above the trade deficit is no bad thing of itself, provided that the offsetting capital surplus can be maintained. The questions to be asked, therefore, are (a) is there any basic structural problem in the Philippines which might operate to cause the underlying trade or overall position to deteriorate? and (b) does the financing of this deficit pose any real problem, or is it something that the financial markets will solve on their own without official prodding?

If a central bank is pursuing a pegged exchange rate policy, interventions in the foreign exchange market are a natural and inevitable counterpart of that decision. Naturally one would expect to see the net foreign exchange assets of the authorities fluctuate over the country's balance of payments cycle. During periods of balance of payments surplus, the net foreign exchange assets should increase, and then decrease during the phase when the balance of payments shifts to deficit. In the Philippines there have been two such balance of payments cycles in the 1970s.

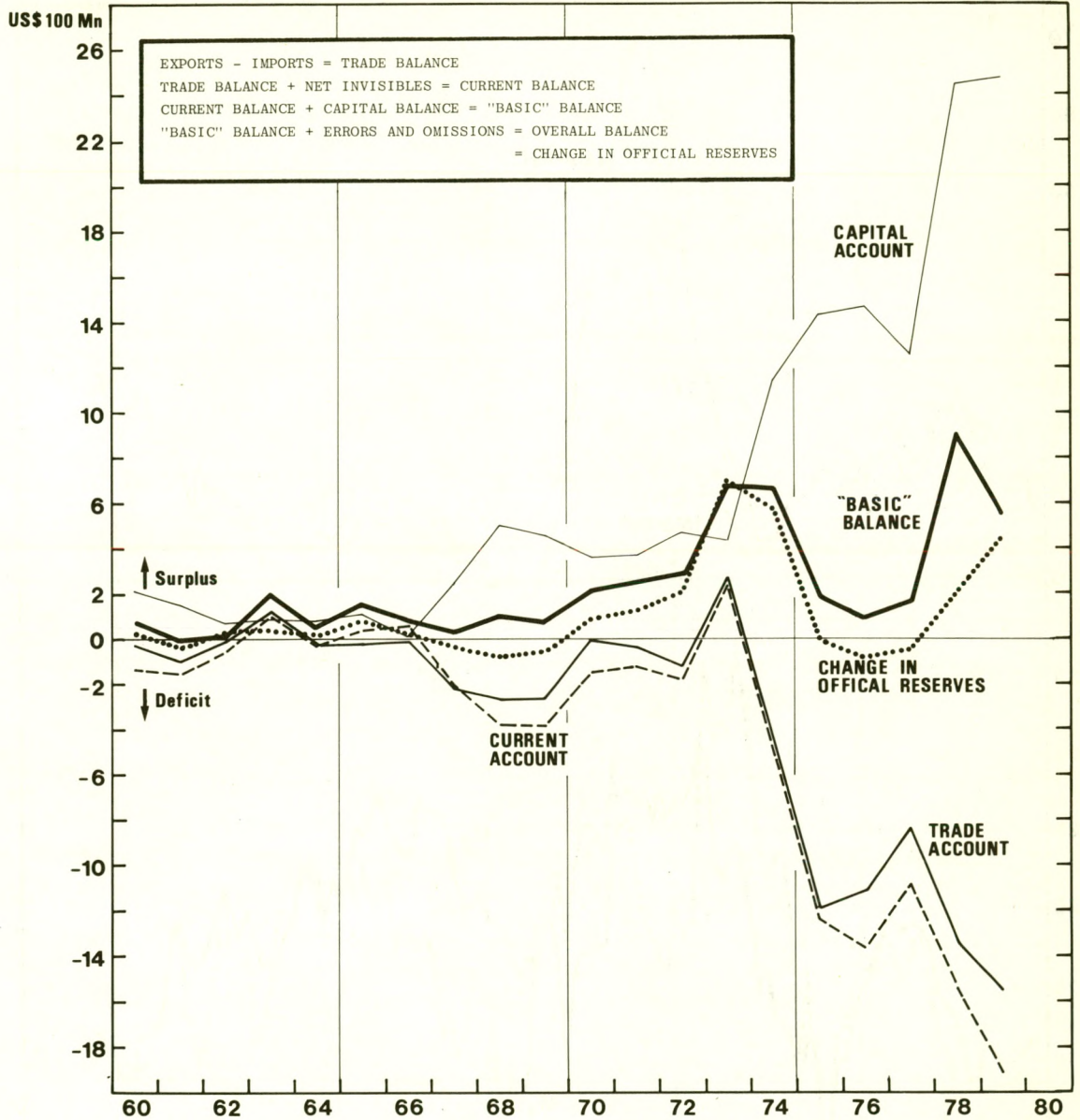
In the first cycle the external position strengthened at first slowly in 1970-72, then quite sharply in 1973-74. This is shown in Chart 2 by the upswing in the basic balance of payments line (current account plus capital account). In 1975 and 1976 all the gains of the four previous years were lost. The second cycle began with the mild upturn in 1977, and was followed by the more decisive upswing in 1978. In 1979 the basic balance deteriorated, and this trend has continued in 1980.

The main contributors to the first upswing were (i) the sharp decline in the trade deficit in 1973 (thanks to the export boom), and (ii) the huge capital inflow in 1974 following six years (1968-73) when there had been very little change in the capital inflow. (The average capital surplus in 1968-73 was US\$434m. per annum; in 1974 the capital surplus was US\$1145m.)

Since 1974 the capital inflow has become very substantial, amounting to over US\$1 billion in each year to 1977, and over US\$2.4 billion in 1978 and 1979. To the extent that the trade and current account deficits have widened relative to GNP since the late 1960s and early 1970s, the Philippines is now more dependent on capital inflows than in the past. Without them the trade and current account deficits would have to be financed from official reserves, and there are clear limits to these resources.

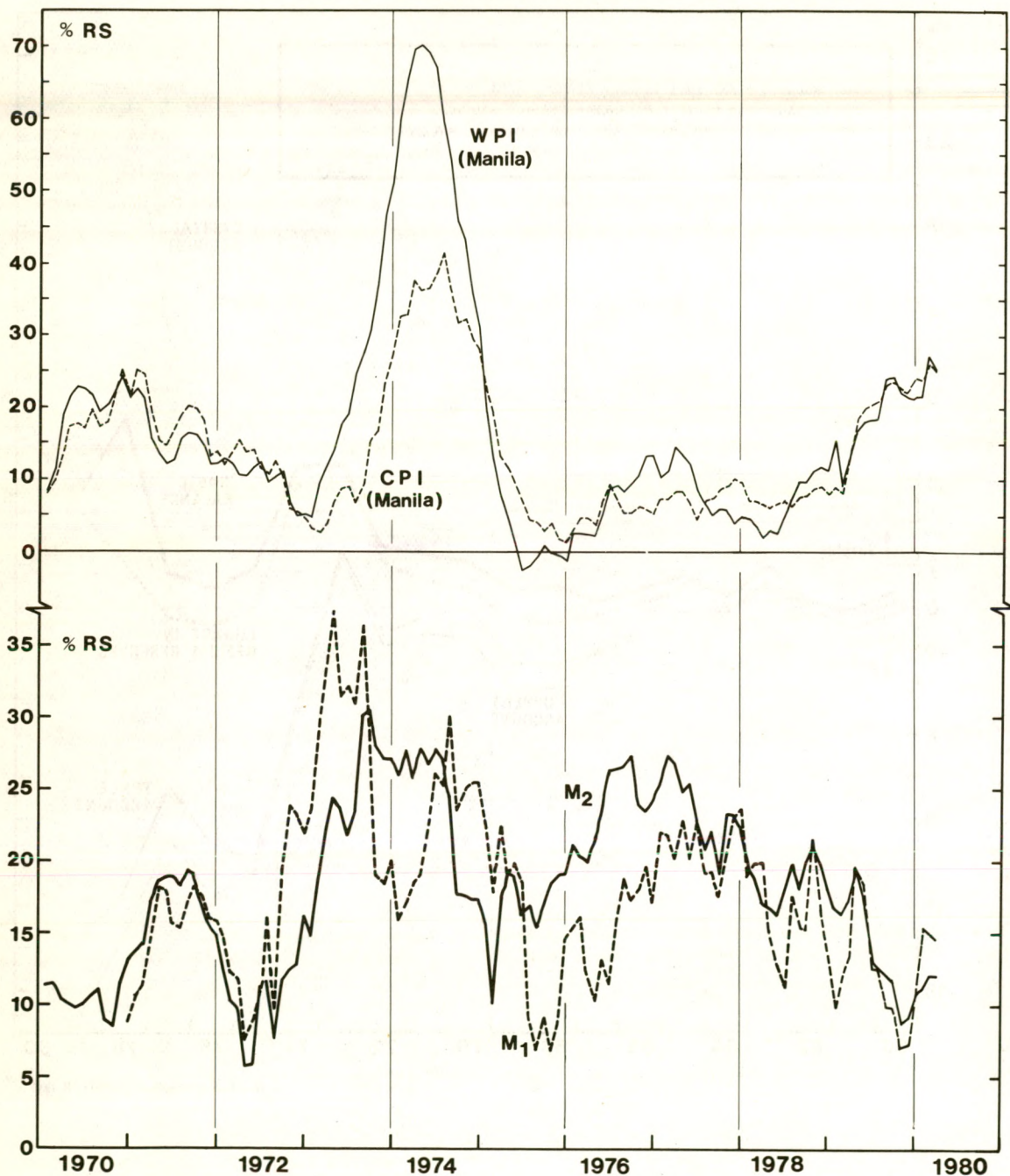
The main contributor to the upswing in the Philippines' overall external position in 1977-78 has therefore been the capital inflow. The trade accounts only contributed in 1977 in the sense that the trade deficit was slightly smaller, and this in turn was due to a 7% increase in imports compared with a

PHILIPPINES
CHART 2 : BALANCE OF PAYMENTS



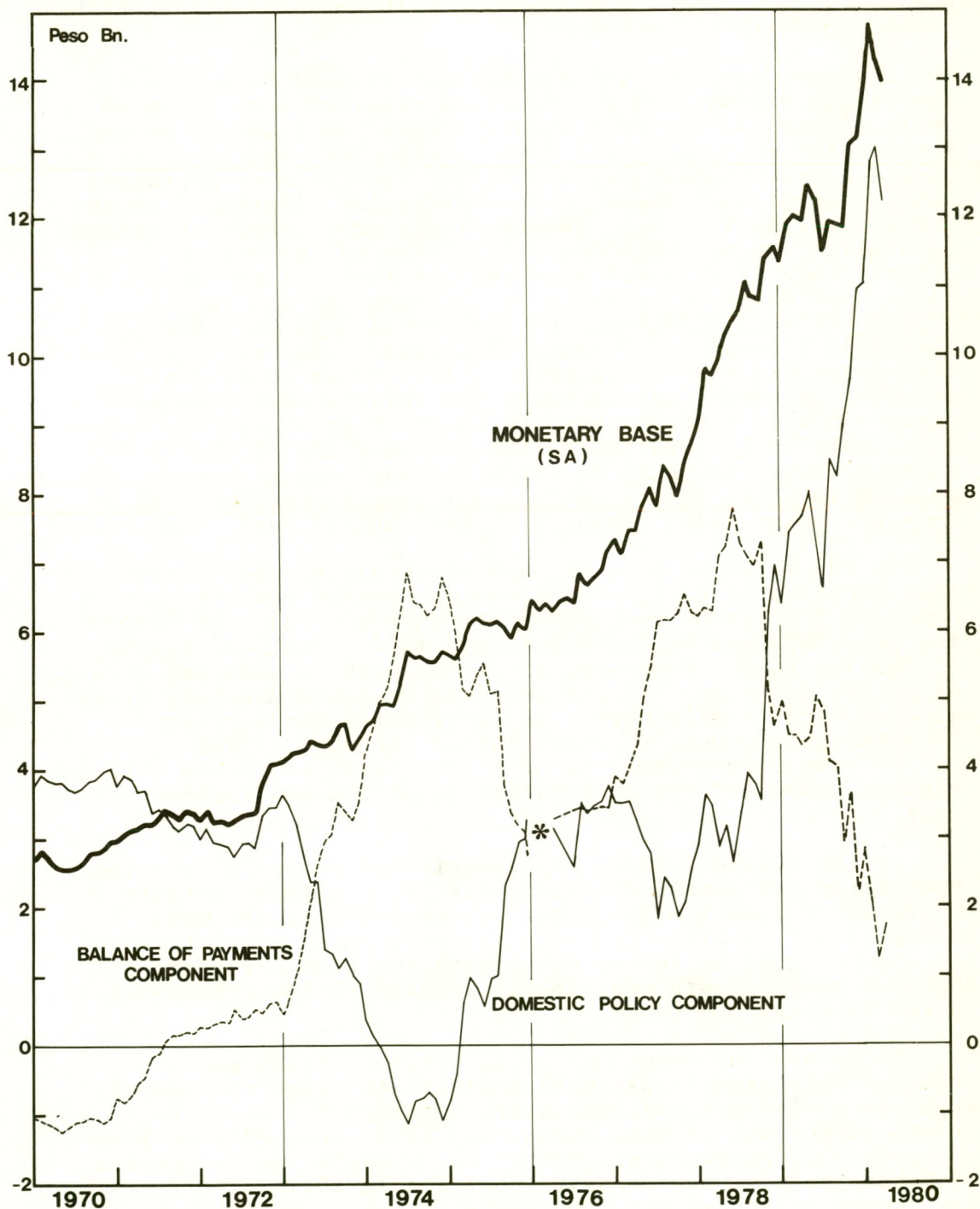
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PHILIPPINES
CHART 3 : MONEY AND PRICES



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PHILIPPINES
CHART 4 : MONETARY BASE AND COMPONENTS



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22% increase in exports. In 1978 the trade account reverted to a more normal pattern as exports rose by just 11% while imports rose by 21%. It was the quantum jump in capital inflow which rescued the external accounts.

The components of the net capital surplus have to a significant extent been government-guaranteed term loans on behalf of quasi-government organisations, or loans to projects in which the government has some equity participation. To a notable degree, therefore, the inflow is very much dependent upon the creditworthiness of the Philippine government in the eyes of foreign lenders. Interestingly that creditworthiness depends in turn upon the domestic stance of the monetary authorities. If they are firm and maintain a tight monetary stance, the external position will strengthen and their creditworthiness will improve. Conversely, if they are lax and allow easy monetary conditions to persist the external position will weaken and the willingness of foreigners to lend will diminish. A useful way to study the relationship between domestic monetary policy and its ultimate impact on the balance of payments is to superimpose the key elements of Charts 3 and 4, as shown in Chart 5. Here the monetary growth (M_2) depicted in Chart 3 is repeated, and superimposed upon it is the net foreign asset position of the Central Bank from Chart 4.

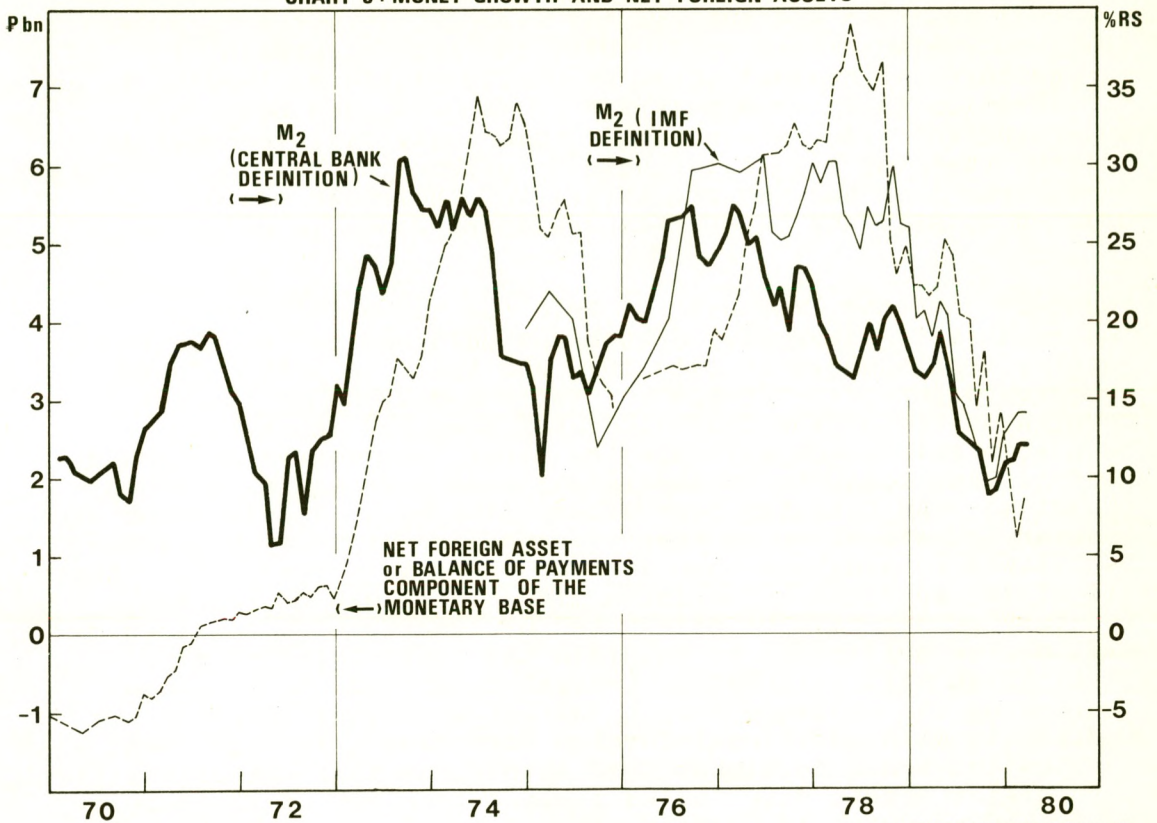
In the first balance of payments cycle the net foreign asset position (i.e. the real foreign reserve position after deducting foreign borrowings by the authorities) rose sharply from late 1972 and early 1973 to mid-1974. The peak in the net foreign assets came soon after the peak in monetary growth, and as the net foreign asset position weakened monetary growth was compelled to slow down. In other words the strength in the external accounts at first lulled the authorities into a mood of easy over-expansion, until the weakness in the external accounts compelled the authorities to switch and tighten their stance.

In the second balance of payments cycle one can see the same pattern of events repeating itself. In this instance the monetary acceleration got under way even before the net foreign asset position had significantly improved, but on the downswing it is fairly clear that the tightening of domestic money growth was closely related to the deterioration in the external accounts.

To answer the questions posed earlier, it is apparent that the only structural problem liable to cause the overall payments position to weaken is the tendency for monetary growth to get out of hand during and after temporary periods of balance of payments strength. For example, if the Central Bank had taken a more decisive position in 1977-78, offsetting the expansion in net foreign assets (Chart 4) by deliberately reducing more than it actually did the amount loaned to domestic commercial banks, rural banks, government agencies, and specialised government banks, the monetary base could have been restrained, and overall money growth held down. As it was the domestic policy component of the Central Bank's balance

PHILIPPINES

CHART 5: MONEY GROWTH AND NET FOREIGN ASSETS

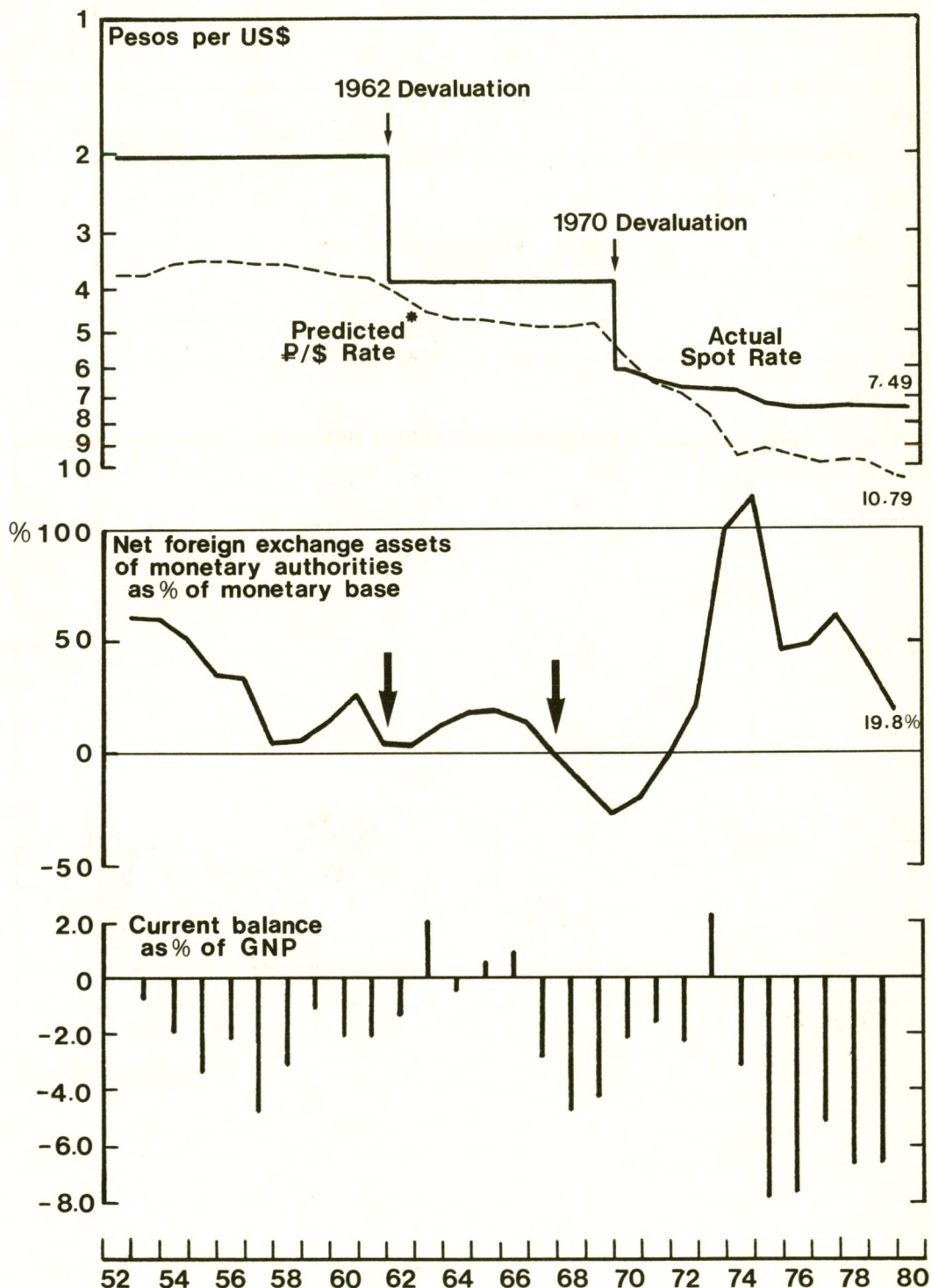


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sheet was not cut back anything like as much as it had been in 1974. In other words, leniency prevailed at a time when the external position was temporarily strong. As monetary growth remained rapid through until 1978, the rate of growth of expenditures in nominal terms gradually picked up leading to an acceleration in imports relative to exports, and hence weakening the trade account. If this analysis is correct it follows that the external funding problems the Philippines faces from time to time are largely of their own making - a delayed consequence of over-expansionary domestic policies.

FORECAST: In the last half of 1978 the authorities at last reversed their easy money stance and enforced an intense though intermittent squeeze in late 1978 and again in 1979. These squeezes ought to be enough to stop the decline in the net foreign assets of the Central Bank. However, there has been some relaxation again in the first four months of 1980 as Central Bank loans for domestic purposes have again expanded (Chart 4), and this has been accompanied by an acceleration of monetary growth shown in Charts 3 and 5. If this relaxation is allowed to progress much further there is a real danger that all of the authorities' efforts since late 1978 to tighten monetary growth will be dissipated because foreign confidence will not be sufficient to maintain the capital inflow at a level which will relieve the Central Bank from its task of shoring up the exchange rate by direct intervention or indirectly with additional foreign borrowing. In that event a devaluation would be almost inescapable now that the authorities' net foreign assets have fallen to less than 20% of the monetary base, and as shown in Chart 6, this devaluation would have to be around 30% to ₱10.80 in order to bring price levels in the Philippines in line with prices in the U.S.A.

CHART 6 PHILIPPINES DETERMINANTS OF THE ₱/US\$ EXCHANGE RATE



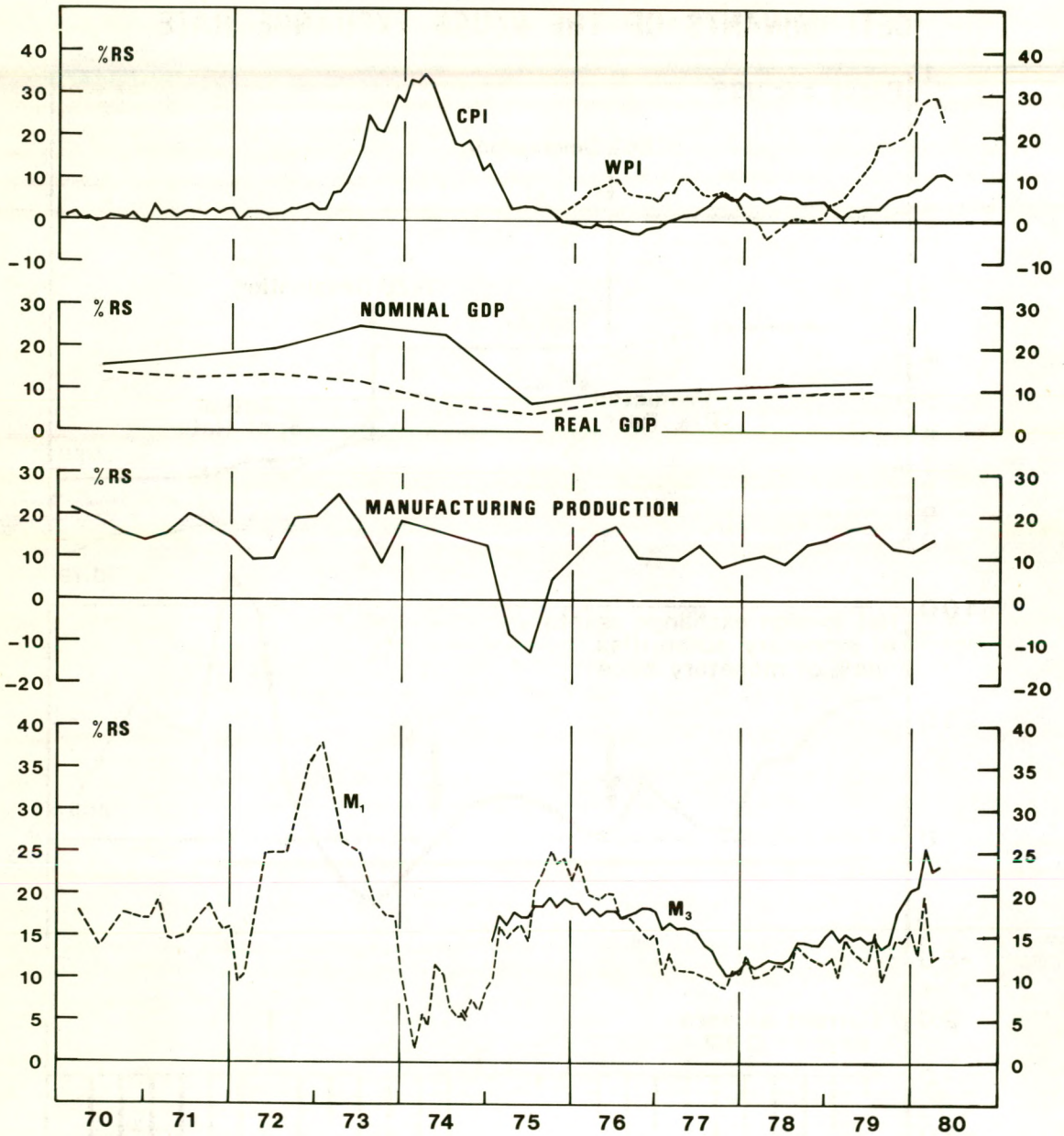
* Based on US and Philippines WPIs;
1971 assumed to be equilibrium year.

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SINGAPORE

CHART 1

MONEY, OUTPUT AND PRICES



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SINGAPORE

MONETARY RESTRAINT ABANDONED

During the past nine months there has been an alarming acceleration of monetary growth in Singapore. The rate of growth of M_2 has almost trebled, rising from 9.0% year-to-year growth in September 1979 to 25.7% by April 1980. Compared with the near-exemplary pattern of restrained monetary growth in the years 1977, 1978 and the first nine months of 1979, this pronounced acceleration in monetary growth marks a distinctive turning point. (See Chart 1.) Up until last year one could be sure that Singapore's currency, which had been the second strongest in the Asian region after the Japanese Yen in 1977-78, would remain firm, and that inflation would stay low. Those comfortable assumptions must now be called in question.

How has this acceleration in monetary growth come about? To answer this question it is necessary to examine the mechanism through which the Monetary Authority of Singapore (MAS) regulates the growth of monetary liabilities in the banking system, or the monetary assets held by the non-bank public.

Bank behaviour in Singapore is regulated under the Banking Act of 1970. The Act sets out, among other things, a three tier reserve asset system which all licensed banks are required to observe. At the first level banks must maintain non-interest bearing deposits with the MAS equivalent to 6% of their "liabilities base". This 6% has to be met on a weekly average basis (Thursday-Wednesday), and only 1% deviations on either side of the 6% average are permitted. The level of liabilities used as a base for the purpose of the 6% requirement is set for each bank by the quantity of qualifying liabilities held on one day each fortnight - normally the first banking day of the month, and then on the 16th (or next banking day if this turns out to be a holiday). Since the deposits of banks at the MAS can be known at any instant by the authorities it is entirely feasible for them, given the determination to do so, to control the growth of licensed banks' liabilities over a period of months. They can do this by selling assets (either foreign exchange or treasury bills or commercial bills) to the banks (or to the four discount houses) and debiting the 6% deposit accounts of the licensed banks at the MAS. The only factors which would constrain the authorities in carrying out these operations are any pre-conceived notions held by the authorities as to (i) what the appropriate "price" of foreign currency should be, and (ii) the appropriate level of domestic interest rates.

A complicating factor in the Singapore authorities' procedure is their maintenance of lagging rather than coincident reserve ratios. Instead of requiring banks to hold 6% of their current liabilities base, the requirement is to hold 6% of their liabilities base up to a fortnight earlier. This means that in the intervening period the banks' liabilities

could expand substantially, and the banks would then spend the next two weeks trying to adjust their assets to ensure that they were in compliance with the requirements. Alternatively - and this is the way the system is regarded as operating in Singapore by both the regulators and the regulated - the banks carry on a normal business until make-up day, and then attempt to reduce their liabilities base to levels which imply reserve requirements that they are sure they can satisfy during the succeeding 2-week period. This results in the interesting phenomenon that instead of money market rates being driven up on make-up day they are in fact bid down as banks attempt to maximise their earning assets and minimise their liabilities base.

The second tier of reserve requirements is known as the Primary Liquid Asset (PLA) ratio. This consists of a requirement that banks hold a further 10% (in addition to the 6% deposits at the MAS) in the form of vault cash, Treasury Bills of the Singapore Government, and Singapore Government Bonds with less than one year to maturity. Any excess balances at the MAS above the 6% requirement may also be counted for this 10% Primary Liquid Asset ratio, but since the MAS does not pay interest on these deposits any available excess is likely to be minimal.

The third and final tier of reserve requirements is known as the Secondary Liquid Asset (SLA) ratio. This is again 10%, and the qualifying assets are as follows: any excess Primary Liquid Assets, Government Bonds with a maturity of more than one year, and 3-month commercial bills (though these may not exceed 5% of the liabilities base).

In sum, the banks must maintain reserve deposits at the MAS and so-called liquid assets equivalent to a total of 26% of their liabilities base. Since the MAS is not the issuer of Government Bonds (though it acts as agent for the Government) nor is it the issuer of private sector commercial paper, the only real or ultimate instrument of control that it has in regulating the growth of the liabilities base of the system as a whole is its ability or willingness to expand or contract the 6% reserve deposits. They are the real fulcrum of the system.

One possible answer to the question of how the acceleration in monetary growth came about could be that the MAS permitted an expansion in reserve deposits and Primary and Secondary Liquid Assets which was consistent with a much more rapid growth of the liabilities base. In the first instance the authorities might have sold Treasury Bills or Commercial bills from their portfolio to contain an unexpected rise in the liabilities base. Although these assets qualify as Primary and Secondary Liquid Assets (PLAs and SLAs) respectively, the banks would still have had to modify their lending behaviour in order to replenish their depleted 6% cash reserve requirement. Such sales by the MAS ought to have put significant upward pressure on short term interest rates in Singapore, but we know from the record of the past nine months that short term

money market rates in Singapore have been relatively stable, suggesting that the authorities were more interested in maintaining stable credit conditions than in restraining monetary growth. In other words it seems probable that the MAS accommodated the stronger demand for credit over the period by allowing money growth to accelerate, rather than resisting it by forcing interest rates up higher.

The increased demand for credit over the October '79-April '80 period was associated with a strong growth in both exports and imports (see Chart 5). The growth rates over the seven months averaged 49.1% for exports and 40.5% for imports (both measured in Singapore \$). Activity in the economy was also at a very high level as manufacturing production (shown in Chart 1) rose by nearly 15% in the first quarter of 1980 compared with the first quarter of 1979.

The fact that money market rates did not rise to anything like the extent witnessed in the United States or in the offshore US\$ markets during the first three months of the year (Chart 6) together with the strength in economic activity in the domestic and external sectors is strange given that the Singapore dollar has been kept within a very narrow band vis-a-vis the US\$ throughout the period. In Australia, where the profile of interest rates was quite similar to that in Singapore, the Australian dollar declined against the US\$ while there was strong upward pressure on US\$ interest rates, and since the beginning of April the A\$ has strengthened against the US\$ as U.S. interest rates have fallen. The difference appears to be that the Australian authorities were willing to allow their currency to fluctuate rather more than the Singaporeans, and as a consequence Singapore's domestic monetary growth has been more affected by the impact of the balance of payments than Australia's monetary growth which has been kept reasonably steady in recent months.

Comparing the monetary experience of Singapore and Malaysia, it is somewhat easier to explain the pattern of events in Malaysia than in Singapore. From Chart 4 it may be seen that Malaysia's monetary acceleration started in early 1979 and gradually built up through the whole year, and, according to the latest available data, it would appear to be still continuing. As with the Malaysian monetary expansion of 1976-77, the current upsurge appears to be associated with the recent commodity price boom, the ensuing improvement in Malaysia's international trade accounts, and the resulting impact of these developments on the domestic banking system. Since the external value of the Malaysian currency is kept pretty closely in line with the Singaporean currency, the upswing in the commodity cycles of 1976-77 and 1979-80 translated into a substantial surplus in Malaysia's overall balance of payments at the prevailing exchange rate.

The improvement in Singapore's external trade position in 1976-77 was not as pronounced as Malaysia's (see Chart 5), and it was therefore probably easier for Singapore to avoid a monetary expansion at this time. Nevertheless, because

Consolidated Balance Sheet
of MAS and Board of Commissioners of Currency

1. Foreign exchange.	4. Notes issued.
2. Treasury bills, other Govt. securities and other items (net).*	5. Coins issued.
3. Commercial bills and other private sector securities.	6. Cash balances of licensed Banks.

(6%) A. Minimum cash balances at MAS.

(10%) B. Primary Liquid Assets.

- i) notes and coins
- ii) balances with MAS in excess of required minimum balance
- iii) net money at call with Singapore discount houses
- iv) Sing. Govt. treasury bills
- v) Sing. Govt. bonds
(of less than one year to maturity)

(10%) C. Secondary Liquid Assets

- i) PLAs in excess of the required 10%
- ii) Sing. Govt. bonds
(of less than one year to maturity)
- iii) cheques payable in Singapore
- iv) commercial bills in S\$
(90 days or less)**

D. Other Loans and Advances.

E. Other Investments
(securities, real estate)

F. Deposits of non-bank customers.

I. Net Worth

** Limited to 5% of liabilities base.

THE LIABILITIES BASE

The liabilities base of Singapore banks is defined as:

- Deposits in all currencies of non-bank customers resident in Singapore
- + net S\$ interbank position (if negative)
- + net S\$ C.D. position (if negative)
- + S\$ deposits of non-bank customers resident outside Singapore
- + net foreign position (=foreign currency deposits less loans and advances in foreign currencies less net foreign currency interbank position)

N.B. If S\$ interbank and C.D. positions are net assets, they may be deducted from the liabilities base.

THE BANKING STRUCTURE

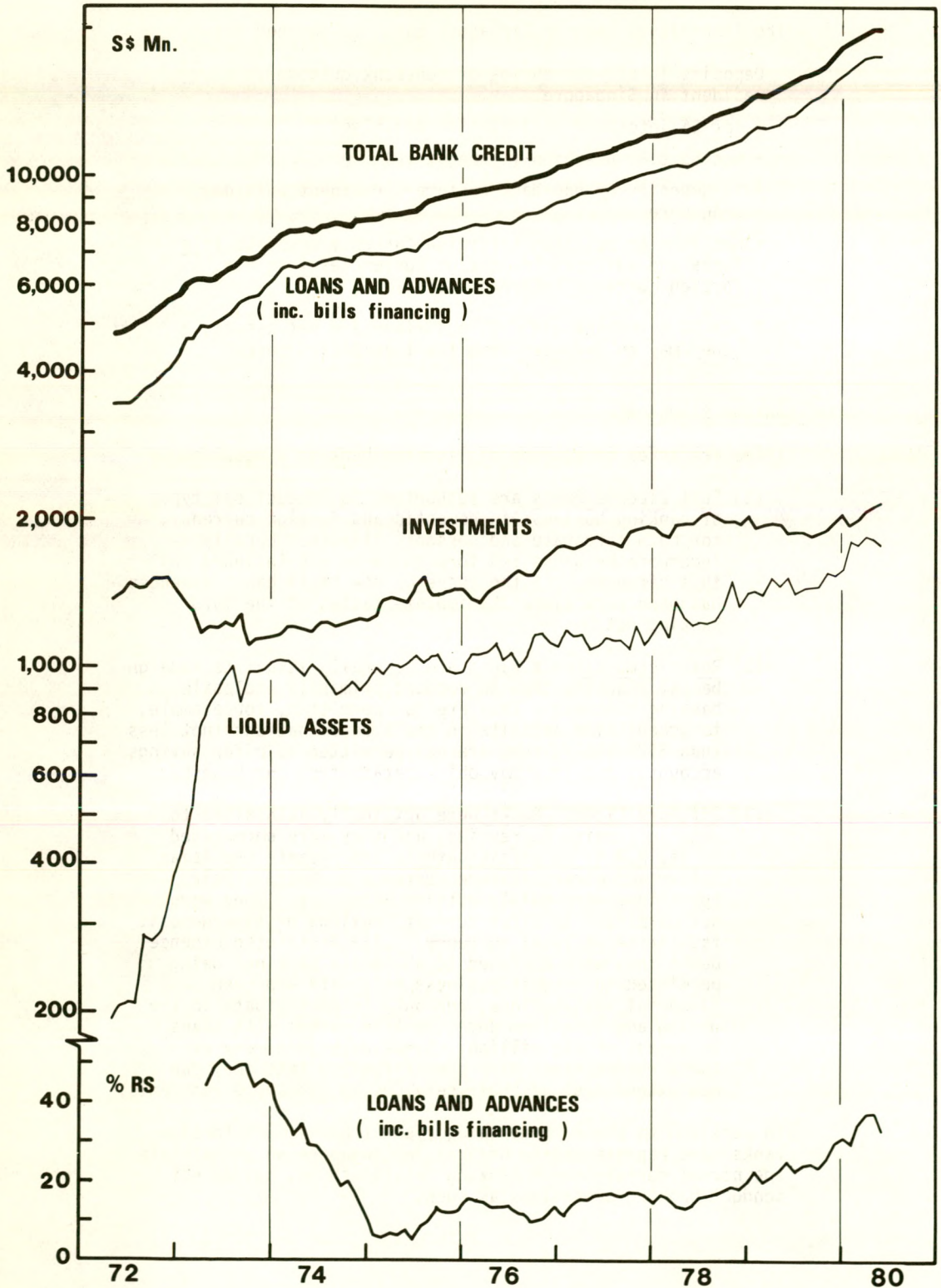
There are three categories of licensed bank in Singapore:

- (1) Full Licence Banks are authorised to conduct all types of banking business in domestic and foreign currency, for both corporate and personal clients. Locally incorporated banks and foreign banks are included in this category, but the issue of new 'full bank' licences has been rare since the implementation of the 1970 Banking Act.
- (2) Restricted Licence Banks are generally issued to foreign banks, enabling them to conduct primarily wholesale banking business. They are not permitted, for example, to accept time deposits in small denominations (not less than S\$250,000), they are not permitted to offer savings accounts, and they may only operate from one branch.
- (3) Offshore Licence Banks were originally authorised to deal in foreign currencies, and they were encouraged by the M.A.S. to participate in and promote the Asian Dollar and other offshore currency markets. Their operations were mainly outside Singapore. They were not permitted to offer current, savings or time deposit facilities in local currency. Like Restricted Licence Banks they were confined to wholesale banking, being permitted to conduct business only with approved financial institutions, and only to participate in the medium and long-term domestic loan market with loans in excess of S\$1 million. Since July 1978 many of these restrictions have been lifted so that they can now extend most of their services to Singapore residents.

In addition to these three categories of banks many foreign banks have representative offices in Singapore which maintain the normal correspondent banking relationships, but do not conduct banking operations as such.

SINGAPORE

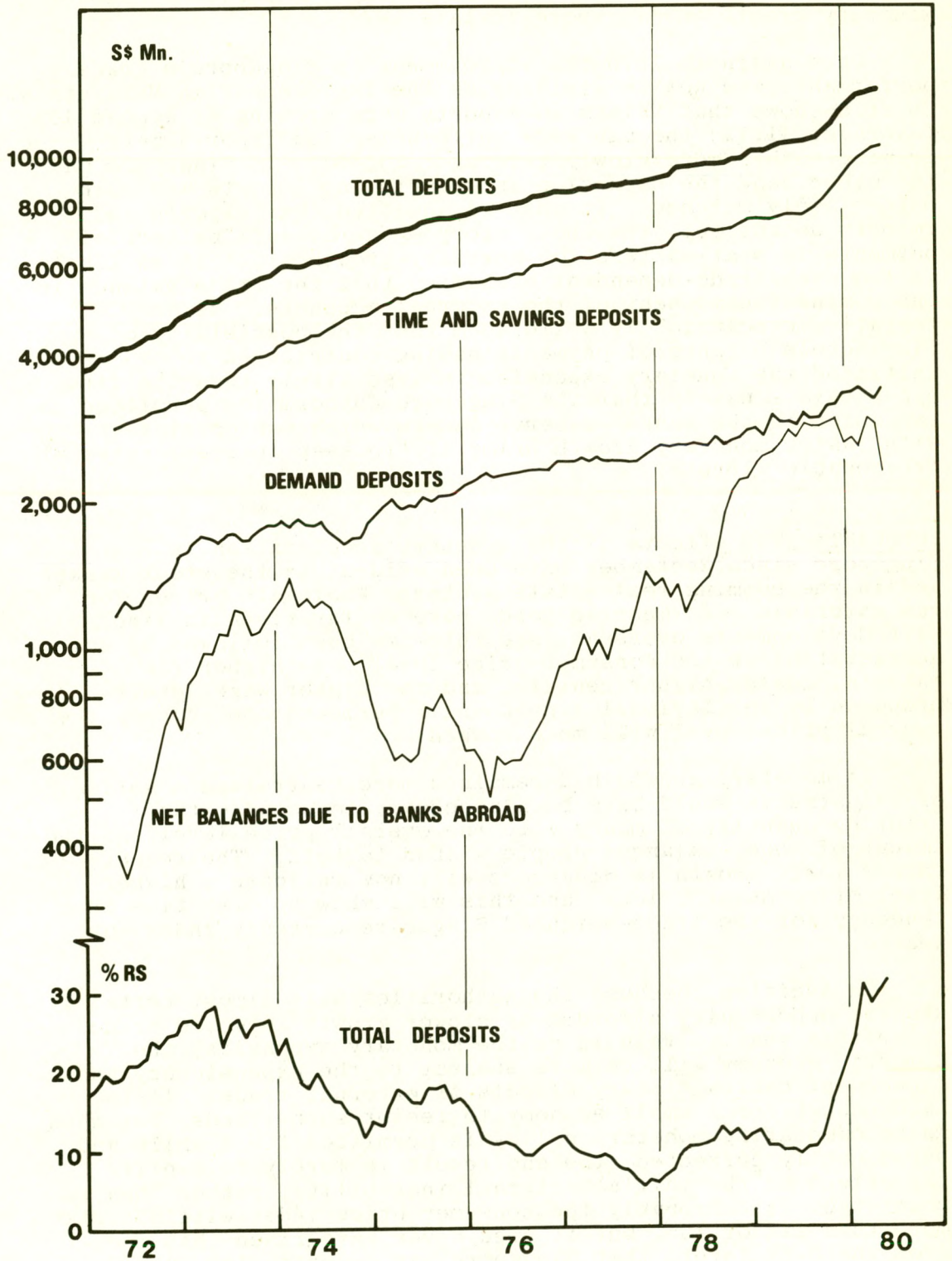
CHART 2 : BANK ASSETS



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SINGAPORE

CHART 3 : BANK LIABILITIES



Singapore's policy was tighter throughout that cycle the Singapore dollar still remained at a premium to the Malaysian ringitt, even improving in 1978 following the period of slower monetary growth in Singapore in late 1977.

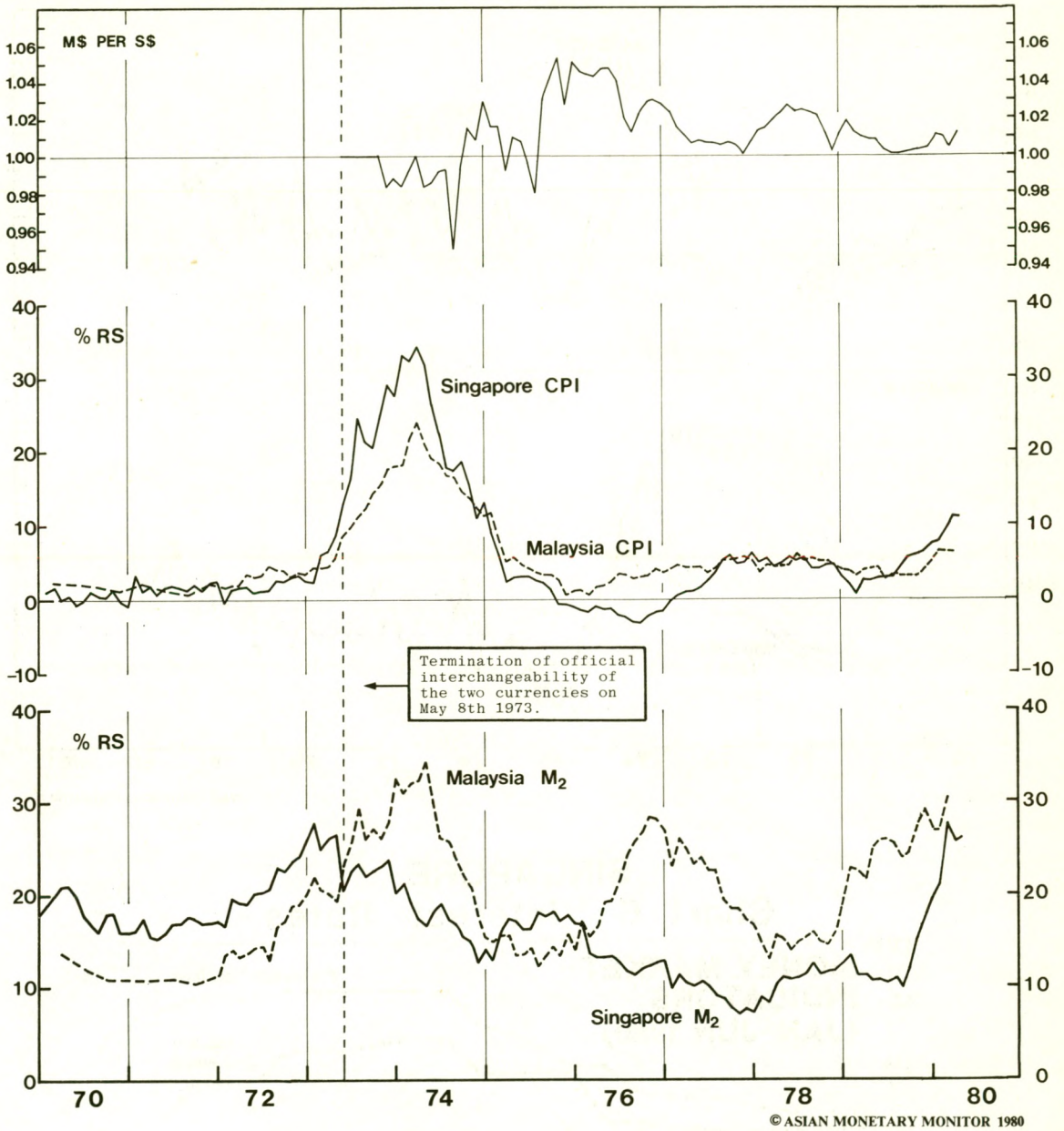
Once again in 1979 the improvement in Singapore's trade performance was not as striking as the improvement in Malaysia's. Chart 5 shows that Malaysian exports were growing at around 40% (average: 41.7%) through 1979 while Malaysian imports were growing rather more slowly (average: 25.4%). In Singapore on the other hand the expansion in exports and imports was much more closely matched. It must be admitted that exports and imports do not tell the whole story - the overall balance of payments is what matters for monetary growth - but it is likely in two such trade-dependent economies that the trade balance is the dominant component of the external accounts. As a tentative conclusion it would seem that the possibility of Singapore's balance of payments having contributed to or initiated the monetary expansion is less likely than the first hypothesis - namely that the Singapore authorities permitted an expansion in the banks' reserve assets which was consistent with faster monetary growth primarily to keep interest rates at 'reasonable' levels.

FORECAST: The effects of the monetary acceleration in Singapore since September have been evident in the stock market and in the booming real estate sector. Wholesale prices for raw materials and imported goods have so far risen in line with developments overseas, and this has been followed by some acceleration at the consumer price level. As higher raw material costs, higher rentals, and the higher wage levels proposed by the National Wage Council permeate the economy the general price level will move upward.

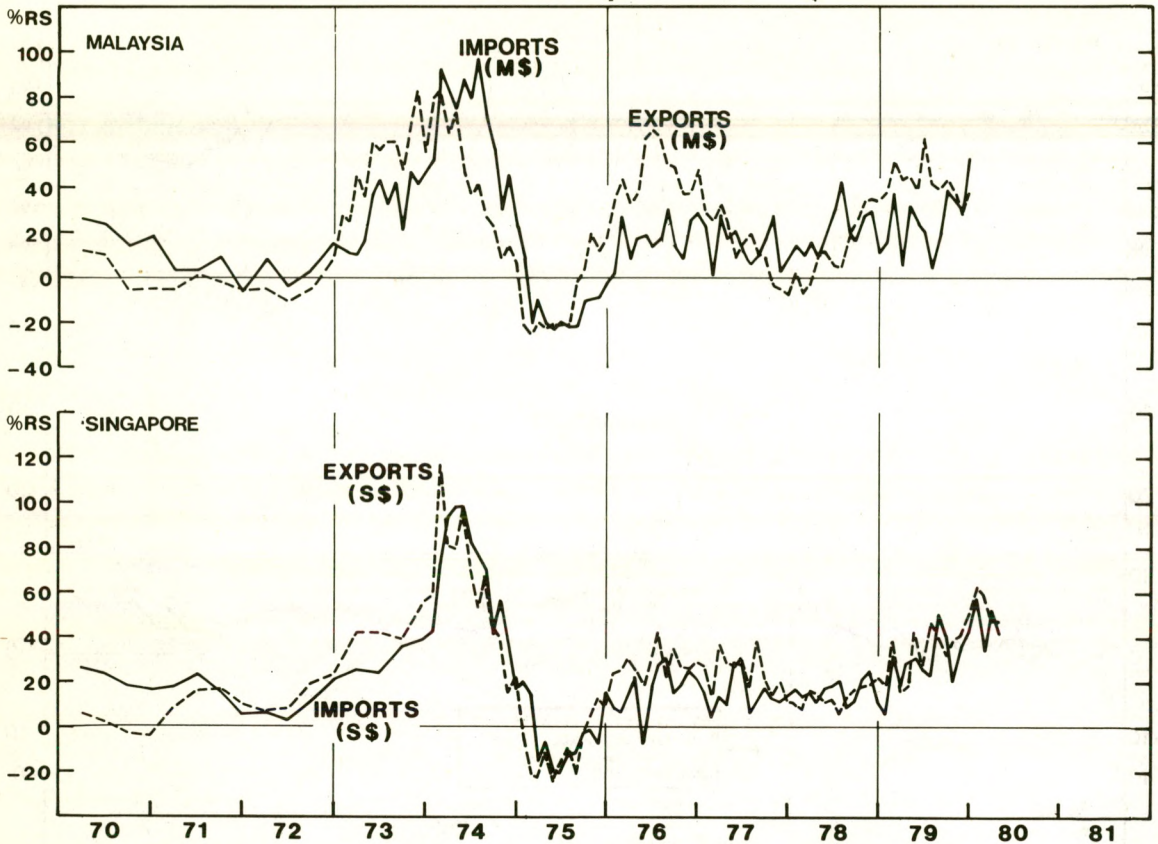
If monetary growth had remained more restrained a series of adjustments would have been necessary to balance the existing quantity of money with the overall price level and the amount of money balances people wished to hold. The recent excess money growth in Singapore will now validate a higher level of consumer prices, and this will show up over time in a tendency for the trade-weighted Singapore currency index to weaken.

In addition, because the authorities will almost certainly use the opportunity afforded by slower growth in world trade later this year to rein in on the monetary expansion, the domestic economy will be more subject to the expansionary and subsequent contractionary effects of external trade. It is hard enough for a small economy to resist such trends, but when an accommodating monetary policy is permitted for a while and subsequently corrected, the end result is merely to amplify the effect of the initial external instability, rather than to counteract it. Probably the consumer price index will not rise more than 12% or 13%, but it need never have risen this much from the 5-6% levels that Singapore was experiencing in mid-1979. Also, the authorities will have to be diligent in their

SINGAPORE AND MALAYSIA
CHART 4 : MONEY, PRICES, AND THE EXCHANGE RATE

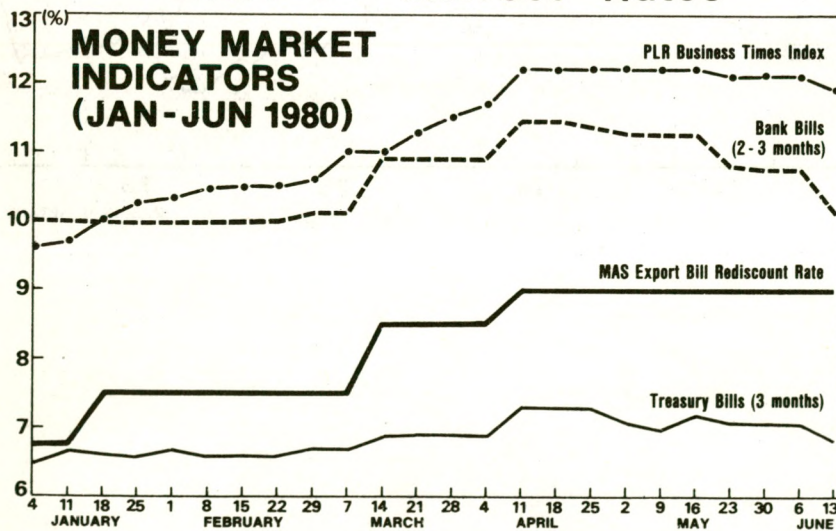


MALAYSIA AND SINGAPORE
Chart 5: Total Exports and Imports



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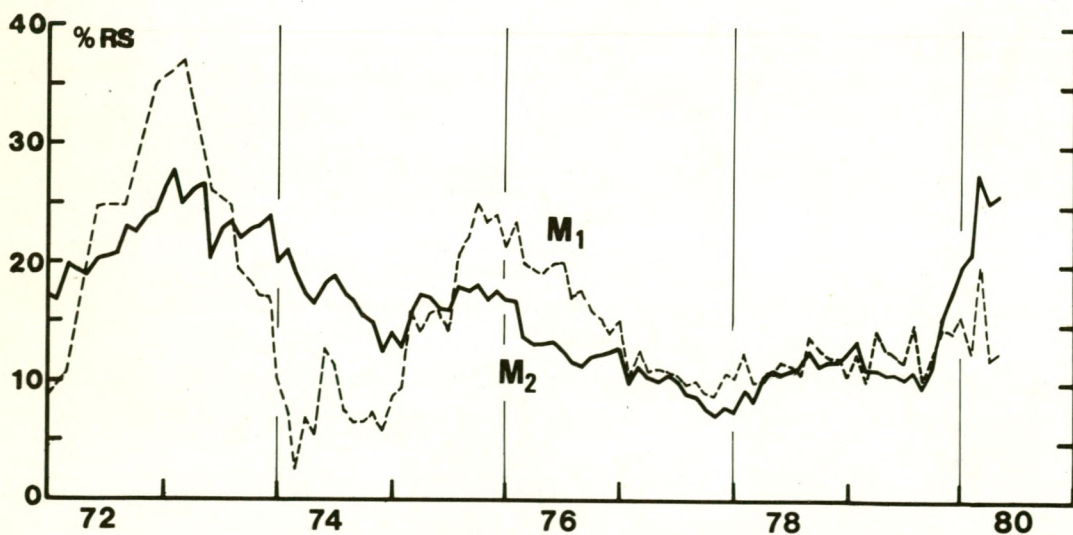
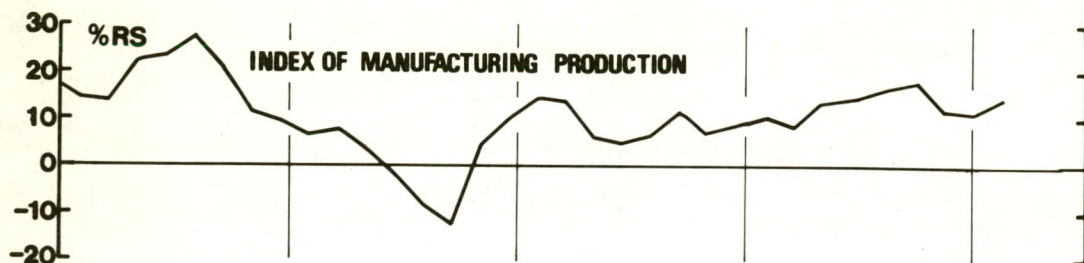
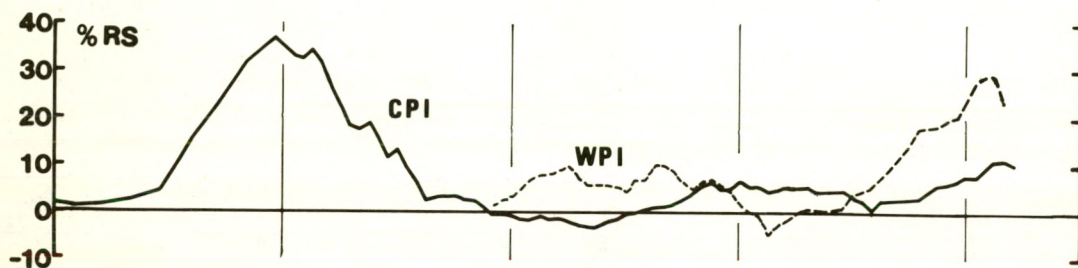
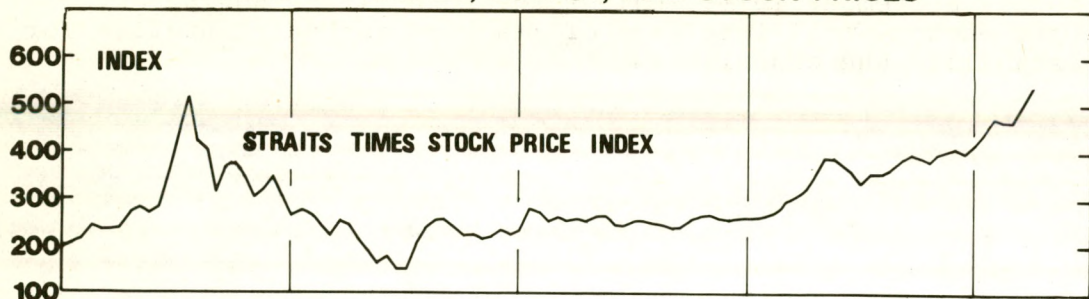
SINGAPORE
Chart 6: Interest Rates



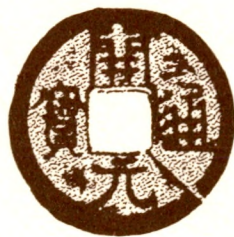
efforts to ensure that monetary growth returns to the proper, restrained course which Singapore so admirably demonstrated until September 1979. Unless the authorities now persevere, the economy will lose some of its hard-earned reputation for stability and orderliness.

SINGAPORE

CHART 7 : MONEY, OUTPUT, AND STOCK PRICES



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EDITORS:

John G. Greenwood

M.A. (Hons) Econ. Edinburgh
Research Economist, University of Tokyo
Economist at G.T. Management (Asia) Ltd.

Christian Wignall

B.A. Econ. Cambridge
Economist at G.T. Management (Asia) Ltd.

Hugh Sloane

B.A. Econ. Bristol
M. Phil. Econ. Oxford
Economist at G.T. Management (Asia) Ltd.

**CHARTS AND
STATISTICS:**

S.Y. Chan

Michael Wong

ADMINISTRATION:

Isabella L.Y. Ling

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KEY TO SYMBOLS USED IN THE CHARTS

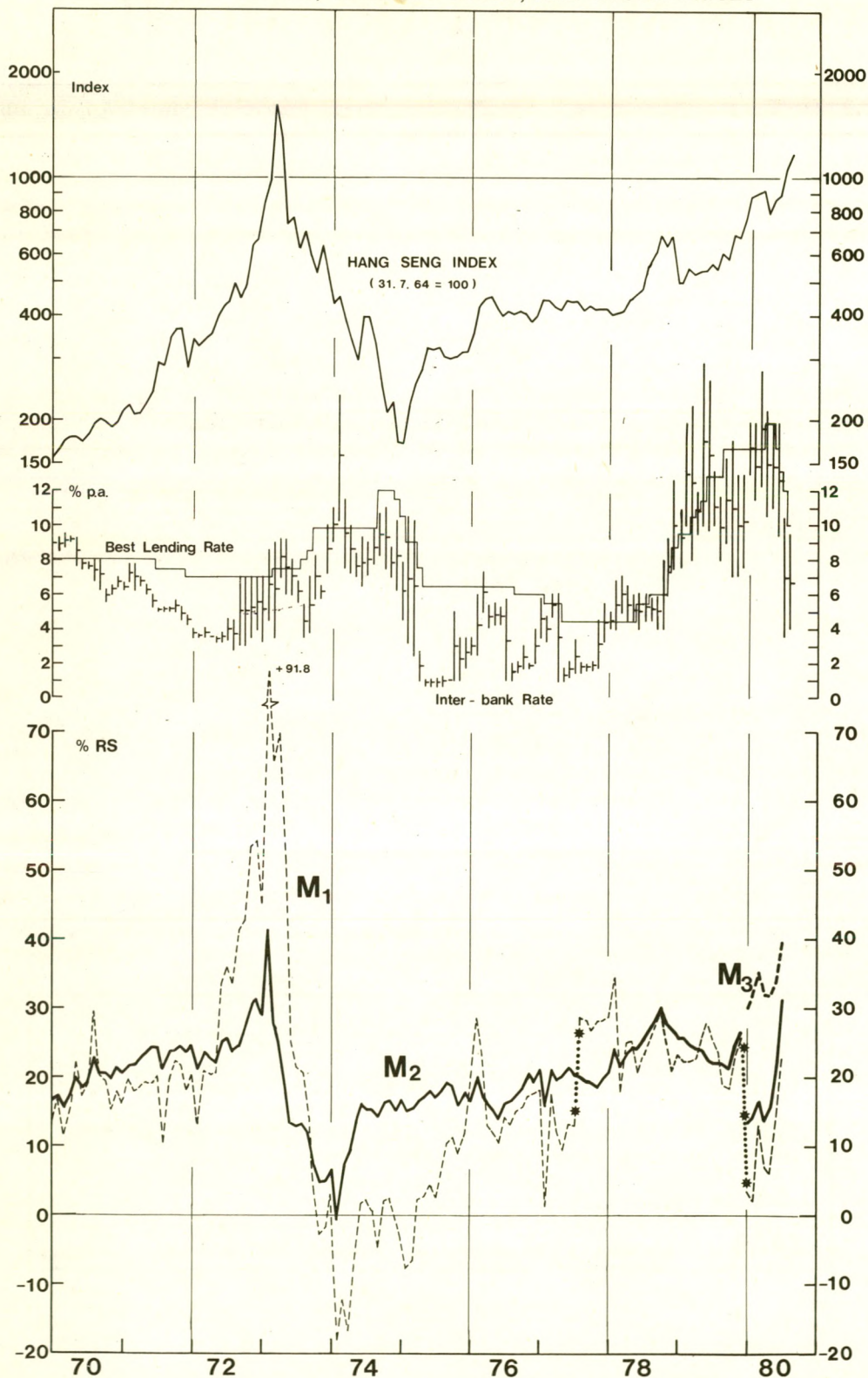
% RP - Percentage Rate of change over Preceding period.

% RS - Percentage Rate of change over Same period of
preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

HONG KONG
 CHART 1: MONEY, INTEREST RATES, AND STOCK PRICES



* Change of data series

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HONG KONG

THE DIRECTION OF INTEREST RATES IN THIS CYCLE

On July 29th the major Hong Kong banks slashed their prime lending rate by two points to 10%. This represents the latest in a series of four cuts which has seen the prime lending rate reduced from a record level of 16% on May 25th. This decline in lending rates lagged larger reductions in both Hong Kong's interbank rate - the fee which banks and Deposit Taking Companies charge on short term loans to one another - and money market rates in the United States. The interbank rate has fallen from a high of around 19% in February to as low as 4% in recent weeks whilst the Federal Funds rate in the United States declined from about 23% to 8% over approximately the same period.

The cyclical reduction in American interest rates during the last US recession was a factor accompanying the very sizeable decrease in the level of Hong Kong interest rates in 1974 and 1975. It has been suggested in some quarters that the precipitous decline in US rates during the second quarter of 1980 will once again act as an important indicator of the trend in Hong Kong interest rates. In view of this it seems worthwhile to study Hong Kong's economic situation during the last recession in some detail in order to discover lessons which may be applicable in discerning the current trends in the level of Hong Kong interest rates.

The upswing in Hong Kong interest rates during the last business cycle can be traced to the third quarter of 1972. At that time the prime lending rate had remained at 7% for almost a year during a period when interbank rate had traded around the 3%-4% level (see Chart 1). The trade balance had begun to show signs of improvement in the first quarter of 1972 and the continuation of this trend (see Chart 2) contributed to the steady increase in the money supply from its trough in 1970. Inflation was at a low level - 6 % in September 1972 - and these two factors created the "easy" liquidity conditions necessary for low levels of interest rates. However, as is typical, the easier liquidity conditions led to a rise in economic activity and real GDP, and upward pressure on inflation. This process accelerated as money supply growth ballooned in the final quarter of 1972 and the first quarter of 1973. However, although the economy was growing strongly and loan demand was expanding at an unprecedented rate - bank loans and advances in 1972 were up an enormous 73.4% from a year earlier - interest rates remained at relatively low levels. This was because money supply growth was also very considerable, and inflation low in comparison to the growth in economic activity. Thus overall liquidity remained relatively "easy" in late 1972 and early 1973 and although the interbank rate rose, prime rate was still only 7½% in the second quarter of 1973.

Moreover, interest rates in Hong Kong's trading partners, particularly the United States, were also at a relatively low level with the Federal Funds rate trading at no more than $5\frac{1}{2}\%$ in January 1973. Since the average interbank rate in Hong Kong at that time was $6\frac{1}{2}\%$ - $7\frac{1}{2}\%$ it seems that the rises in domestic rates were not of a defensive nature and were generated domestically.

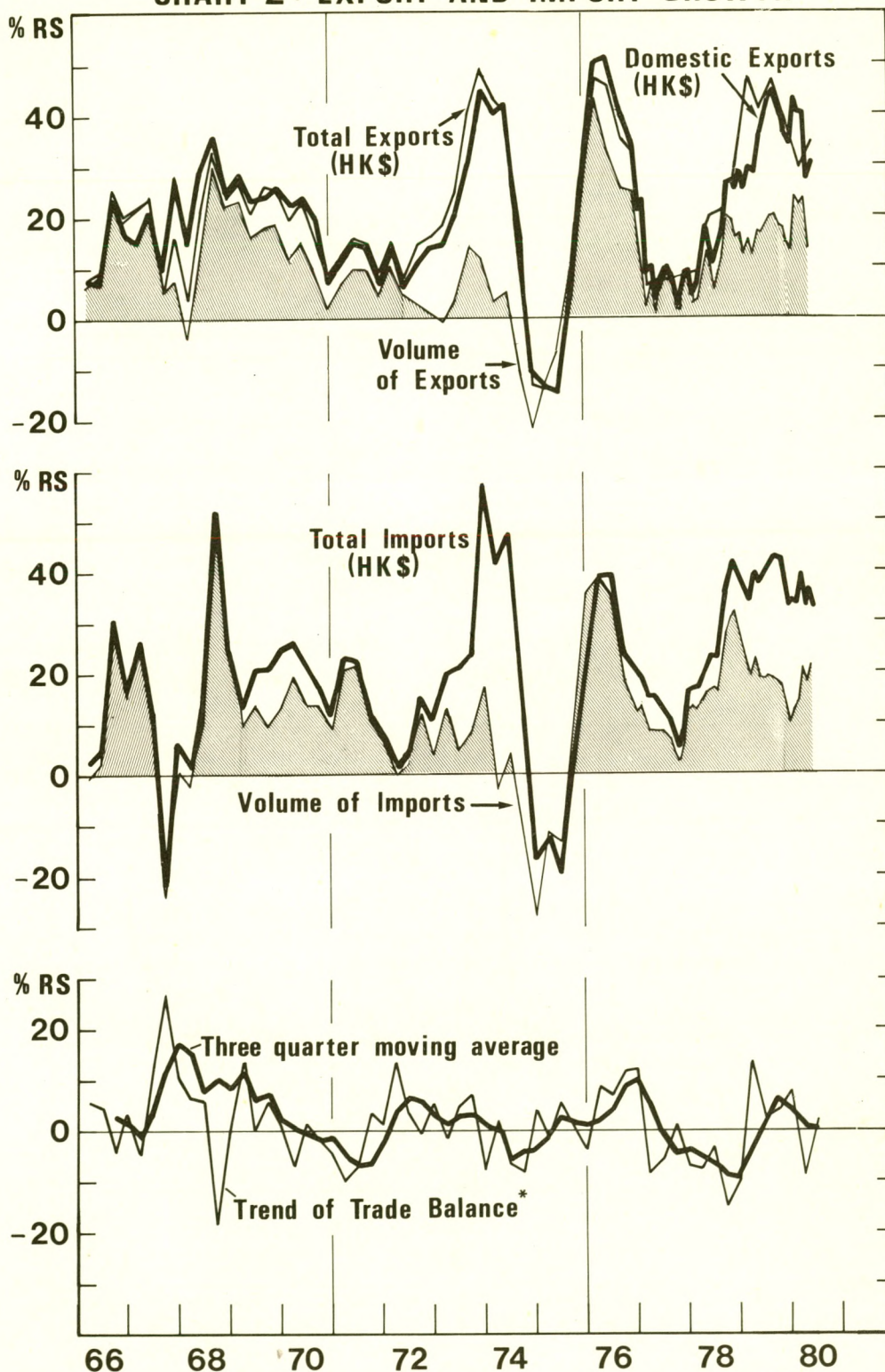
In 1973 and 1974 the trend in Hong Kong's trade position deteriorated and the combination of a domestic boom and the fixed exchange rate with the US dollar must have produced a large balance of payments deficit leading to a sharp contraction in monetary growth. Because of the lags with which output and inflation respond to changes in the money supply these conditions spelled a severe impending liquidity squeeze. Banks' average liquidity ratio fell from 46% in December 1972 to 41% in June 1973 (raising pressures in the interbank market), whilst over the same period their loans-to-deposit ratio increased from 0.72 to 0.85, thereby precipitating the increases in prime lending rates in the second half of 1973. The fact that the slowdown in inflation and output in the real economy lagged the contraction in the money supply effectively implied that the demand for money was growing at a faster rate than its supply: in September 1973 bank loans were still up 43.1% on the previous year whereas M_2 had only increased by 7.5%. Hence liquidity tightened and interest rates rose.

What general comments which can be made about interest rates in the 1972-1975 period? It is important to note that the interest rate cycle during the last recession was the inevitable corollary of the automatic adjustment mechanism resulting from a fixed exchange rate system. The interest rate cycle may be divided into two parts. Initially the increase in the level of interest rates stemmed from a liquidity squeeze in the domestic economy following a contraction in the supply of money whilst the economy was still growing strongly. The fall in the money supply was a direct result of a deteriorating external sector. It was probably only later, in the third quarter of 1974 when US rates reached their peak, that the level of foreign interest rates had any significant impact on the domestic market. However, by then domestic liquidity had already started to ease: real GDP growth had fallen sharply, inflation was declining and the money supply had recovered from its cyclical trough. It was therefore not surprising that interest rates declined as rapidly as they did in late 1974 and early 1975.

Clearly the economic conditions accompanying the increase and subsequent decline in Hong Kong rates this year are very different from those in the last cycle. Although inflation is rising and the trade position weak there have been virtually no indications that the Hong Kong economy is following the US into recession and real GDP is continuing to expand at about 10% per annum. As we have argued on numerous occasions in past editions of AMM, there is no longer an effective mechanism which prevents banks from meeting the very rapid growth in loan demand which high nominal GDP increases create, and the

HONG KONG

CHART 2: EXPORT AND IMPORT GROWTH



*The rate of growth of total exports minus the rate of growth of imports

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CHART 3: MONEY, OUTPUT INDICATORS, AND PRICES



counterpart of which is a surging money supply. Therefore there has not been a domestic liquidity squeeze and consequently it is doubtful whether the rise in interest rates during the first quarter of 1980 was the consequence of domestic pressures.

In some sense, the decline in Hong Kong interest rates during the second quarter of 1980 is similar to that during 1974, for on both occasions US interest rates dropped at a time when Hong Kong's overall liquidity had become relatively easy. However, the similarity ends there since in late 1974 falling inflation and a low level of economic activity in Hong Kong represented downward domestic pressure on rates which was independent of the interest rate cycle abroad, and it was because of this that Hong Kong interest rates were able to maintain a low level during 1975. In the current cycle, although US rates have fallen further and more rapidly than in 1974, the economic fundamentals in Hong Kong do not support an additional impetus towards lower domestic rates. Indeed, in the absence of further declines in US rates, rising inflation and loan demand imply that in the longer term accelerating monetary growth is necessary if Hong Kong interest rates are to remain at current levels.

Early in June when Hong Kong's prime lending rate was at 13% the Exchange Banks Association, apparently recognising some of the dangers inherent in rapid money supply growth, issued the following statement: "The continuing need to maintain a relatively high interest rate structure for monetary purposes is likely to preclude further reductions (in the prime lending rate) in the near future." Why then did the EBA reduce prime by a further three points when it realised that this was probably an inappropriate measure from the point of view of conditions in the domestic economy? A significant part of the answer lies in the EBA's role as a private cartel. In AMM Vol. 3 No. 5 we commented that "the EBA will generally regulate interest rates with a view to maximising the joint objectives of its member banks". The implication of this is that the EBA will always tend to adjust the prime lending rate to increase their profitability, irrespective of what may be appropriate for the economy. The EBA went some way to confirming this when, in justifying the latest cut in prime rate, it pointed out that prime rate had recently been significantly higher than the interbank rate. Because of this, the major banks had been losing market share to the finance companies who had been able to undercut them: Banks' loans and advances in Hong Kong grew a paltry 11.3% in the first half of 1980, compared with a 58.2% rise in the domestic loans and advances of Deposit Taking Companies. The decline in US rates and easy domestic liquidity conditions forced the banks to respond to competition from the DTCs despite their acknowledgement that economic conditions in Hong Kong did not merit a reduction in the prime rate.

During the last business cycle, indeed for the whole of the period when the Hong Kong dollar was a pegged currency and where there existed an indirect control over the money supply, there was always a determinant level of interest rates in the Hong Kong economy. This level resulted from a combination of

domestic and international influences. The domestic component was that level which equated the demand for dollars within Hong Kong to a fixed supply. This differs, conceptually, from the international component which was the level of interest rates necessary to maintain the Hong Kong dollar at a fixed price relative to the US dollar. So, pre-November 1974 the level of interest rates in Hong Kong was determined by the need to balance the supply and demand for Hong Kong dollars both within the domestic economy and abroad. Because inflation and real economic activity - both important influences on the demand for money - tend to lag changes in the money supply (see for example the troughs in monetary growth in 1965, 1968, 1970 and 1974 illustrated in Chart 3) interest rates always tended to rise whenever monetary growth slowed, as in 1973. However the price which equated the demand and supply for money in the domestic economy was not necessarily that which enabled the exchange rate to be maintained at a constant rate. Thus, for example, there was a "secondary" increase in Hong Kong rates in 1974 when the trade position deteriorated further and when US rates were at their peak, even though domestic conditions warranted easier liquidity.

In the current business cycle it appears that there is no longer a determinant level of interest rates in Hong Kong. On the external side, there is no necessary reason for domestic interest rates to adjust in order to maintain any particular price of the Hong Kong dollar vis-a-vis any other currency since the dollar is now "floating". On the other hand there is no longer any reason to expect interest rates to change because of a mismatch between the supply and demand for Hong Kong dollars in the domestic economy since the banks may now increase the money supply to meet any level of demand. Thus we would expect total lending and money supply growth to be approximately equal. Official statistics show this to be the case since the beginning of 1980 when the monetary and lending series were revised to take account of DTC loans and deposits.

FORECAST: Given that the banking system in Hong Kong is structured in such a way that there is no effective constraint on banks and DTCs meeting any level of credit demand, the money supply is likely to be determined by the demand for money. Under such circumstances it is therefore improbable that there will be an excess supply of money relative to its demand. Thus a domestically induced reduction in interest rates is unlikely.

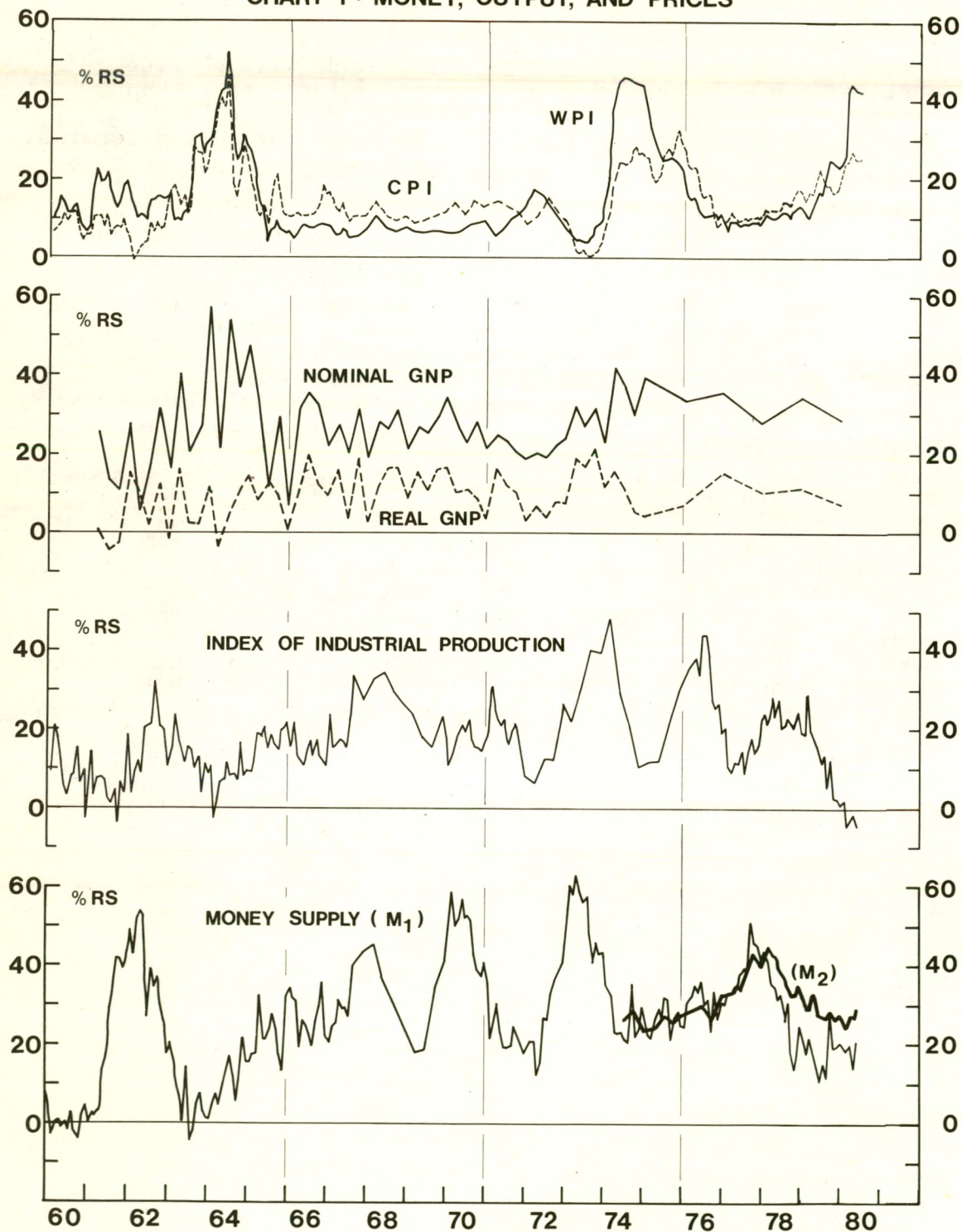
Similarly, since the supply of money can adjust to whatever the demand, domestically induced upward pressure on Hong Kong rates is also unlikely since it would be surprising if an excess demand for money relative to its supply developed under such circumstances. Of course it is possible that the EBA may decide to raise its prime rate in order to try to combat inflationary pressures. However, since this has no impact on the amount of reserves in the banking system, and since it is unlikely that the EBA can manipulate the interbank market in anything but the short term, it seems likely that the only result of such an action on the part of the EBA would be

to widen the differential between prime and interbank rate. In other words it will determine the relative market share of the EBA and finance companies.

This tendency for the money supply to adjust in order to prevent an excess supply or demand for funds will be true whatever the existing level of interest rates. What then determines the level of interest rates in Hong Kong? The answer appears to be that Hong Kong rates are broadly determined by the levels existing in international markets. In order to meet additional loan demand in Hong Kong there are essentially three ways in which it is possible for individual banks and DTCs to acquire Hong Kong dollars. First, they may increase their deposit base. Second they could borrow from the interbank market. Third, they may sell foreign assets. A conceptually similar but alternative method to the third option is to borrow foreign currency, buy Hong Kong dollars on the spot market and simultaneously sell the Hong Kong dollars forward (i.e. buy the same foreign currency forward). Theoretically, these various ways of funding should have an identical cost. Thus if interest rates in Hong Kong are generally lower than abroad the banks and DTCs will bid up interbank and deposit rates, to the level where these methods of funding are equal to substitute (i.e. foreign) sources, and vice-versa.

There are two general problems. First, from the investment managers' point of view, although it may be true that the level of interest rates in Hong Kong is determined from abroad, we cannot say which foreign rates in particular most influence those in Hong Kong. We can only say that during periods of declining or increasing rates world wide, Hong Kong's rates will inevitably follow. The more general problem is that changes in interest rates in Hong Kong will not typically reflect economic adjustments at home. The level of Hong Kong interest rates is more a reflection of the economic adjustment process abroad than of cyclical changes in the domestic economy.

SOUTH KOREA
CHART 1 : MONEY, OUTPUT, AND PRICES



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SOUTH KOREA

MONETARY ACCELERATION UNDERMINES DEVALUATION

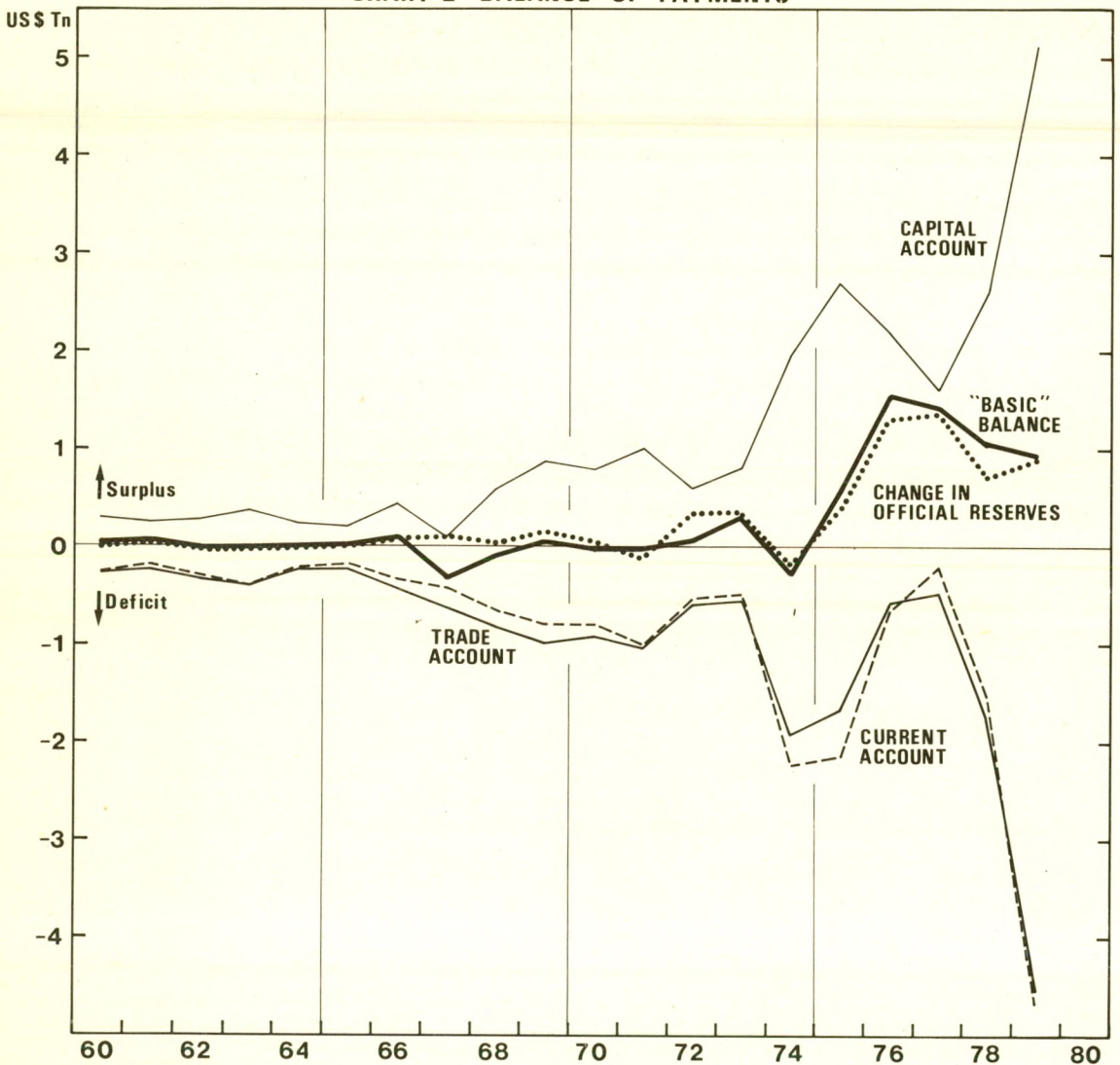
On January 12th 1980 the Korean authorities alleviated some of the external pressures on their economy by devaluing the Won by 16.55%. On June 5th 1980 they relaxed their internal discipline as well; in a package of economic measures they abandoned the 20% growth target for M_2 which they had earlier announced and substituted a more easy-going target of 25%. Subsequent to that the budgetary proposals for next year have begun to be assembled. Released at the end of July, preliminary estimates for total government expenditures proposed a rise of some 114%. Faced with such bureaucratic profligacy, officials at the Economic Planning Board instructed the various ministries and government agencies to cut this figure back drastically to a 40% increase - a figure which is held to indicate "restraint".

Just like a drug addict who has been enjoying a "high" for several years the Korean economy is now suffering withdrawal symptoms. But the patient is finding it tough to go "cold turkey", and is resorting to comforting doses of the drug again.

The drug in the Korean case was the easy money policy of 1977-78. During that period the monetary aggregates grew at annualised rates of over 30%. Between December 1976 and December 1978 M_1 grew at 32.6% p.a., and M_2 grew at 37.0% p.a. The initial results were deceptively re-assuring. After slowing down sharply in late 1976, industrial production began to pick up again so that by the end of 1977 it was bustling along at over 20% p.a., a pace which it maintained until mid-1979. (See Chart 1.) Through most of this period consumer price inflation remained fairly consistently at around 10-12% on a year-on-year basis. The external accounts were also in good shape - at least until early 1979. Then things started to go wrong.

The trade deficit, which had reached US\$2,261 million in 1978, or an average of well under US\$200 million per month, suddenly began to record monthly deficits in excess of US\$400 million per month. For the whole year of 1979 the trade deficit came to US\$5,284 million. (See Chart 2.) The inflation rate, which had averaged 10.1% in 1977 and 14.4% in 1978, reached 21.2% by December 1979. Import prices and wholesale prices showed steeper increases of 37.8% and 23.8% respectively for December 1979. To slow the economy and counter the inflation a monetary squeeze was imposed. But when the figures reported at the beginning of this year revealed that there had been no discernible improvement on the external front in the final quarter of 1979, and inflation was showing no signs of abating, the authorities bit the bullet and devalued the Won.

S. KOREA
CHART 2: BALANCE OF PAYMENTS



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The reaction of the economy to the devaluation was not exactly as the authorities had hoped. At first prices of imported goods rose sharply: in the first quarter they rose by 36.4% over the same quarter of the previous year. But the authorities' primary intention was that the economy should recover rapidly through export growth, assisted by the devaluation. However, the slowdown of the Korean money aggregates had already been proceeding for almost two years, and since the domestic inflationary fires from the earlier rapid pace of monetary expansion were heating up, real purchasing power in the domestic economy was contracting sharply. The extent of this collapse in real purchasing power is shown in Chart 3. With such a liquidity contraction

in progress, the private sector naturally became extremely cautious about its expenditure plans. Businesses cut back on investment plans, while consumers became much more tight-fisted. With real economic growth forecast to plunge from 7.1% in 1979 to below 2% in 1980, Korea was facing the prospect of its first serious slump. The economy's domestic problems were compounded by the downturn in activity in the United States from February. It was against this background that the government produced its package of economic measures to bolster the flagging economy on June 5th.

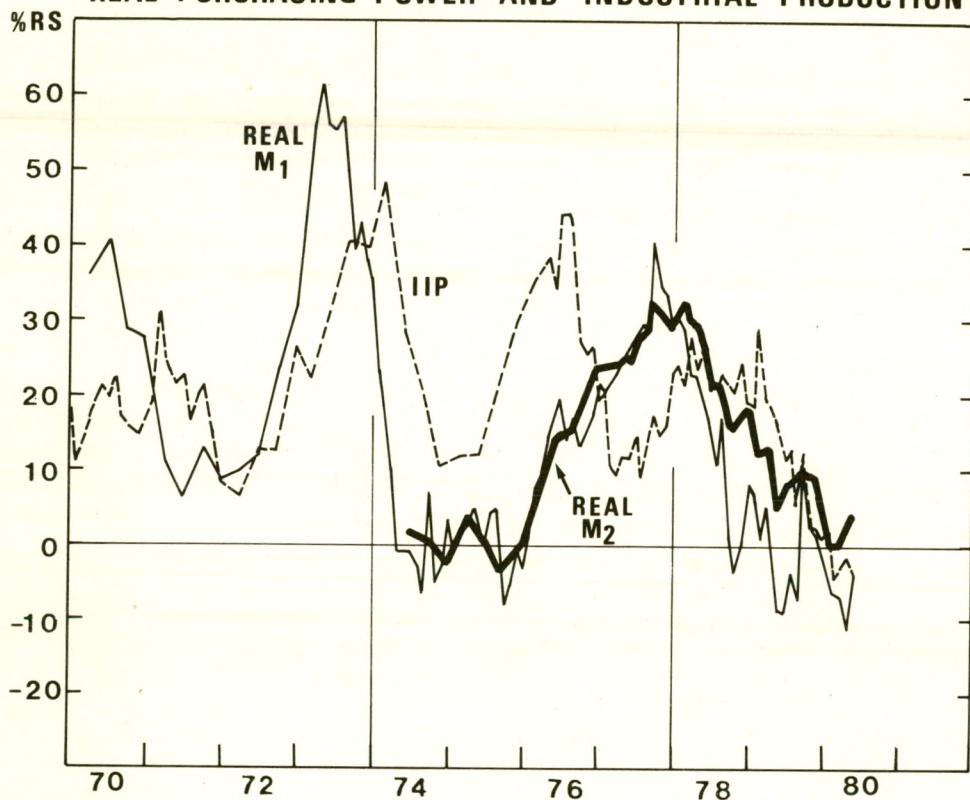
In essence the economic programme attempted to revive activity by adding to purchasing power. On a broad macro-economic basis the mechanism for achieving this was the deliberate acceleration in monetary growth to 25% p.a. (for M_2). The credit counterpart of this decision was that additional bank loans would be made available to the private sector. Therefore the ceiling on new domestic credits was lifted from Won 4,110 billion to Won 4,655 billion, so that total credit would rise from just under Won 12,000 billion at the end of 1979 to almost Won 16,500 billion at the end of this year. Thanks to this injection of additional liquidity the authorities were also able to lower interest rates - at least initially. Much publicity was also given to the government's intention that these measures would reduce the projected unemployment rate from just under 6% to 5%. The country's real economic rate, which had originally been optimistically forecast at 3-5% for 1980 and which had been revised down to between 0 and 2%, would be restored to 3-4%.

On the fiscal side the measures included subsidies for transportation and certain basic necessities which were considered to help low-income groups. Support was to be given to agriculture, small and medium-sized industries (who were also designated as the beneficiaries of the additional credits to be extended), and increased expenditure on construction and other public works to boost or maintain employment in these sectors. Finally, to underpin the January devaluation some further export-promotion measures were adopted such as easier credit terms, and the postponement of an interest hike that had been planned for export-related imports.

How successful is the new economic programme likely to be? The remainder of this article will be concerned with the impact of the programme on real growth and on the external accounts.

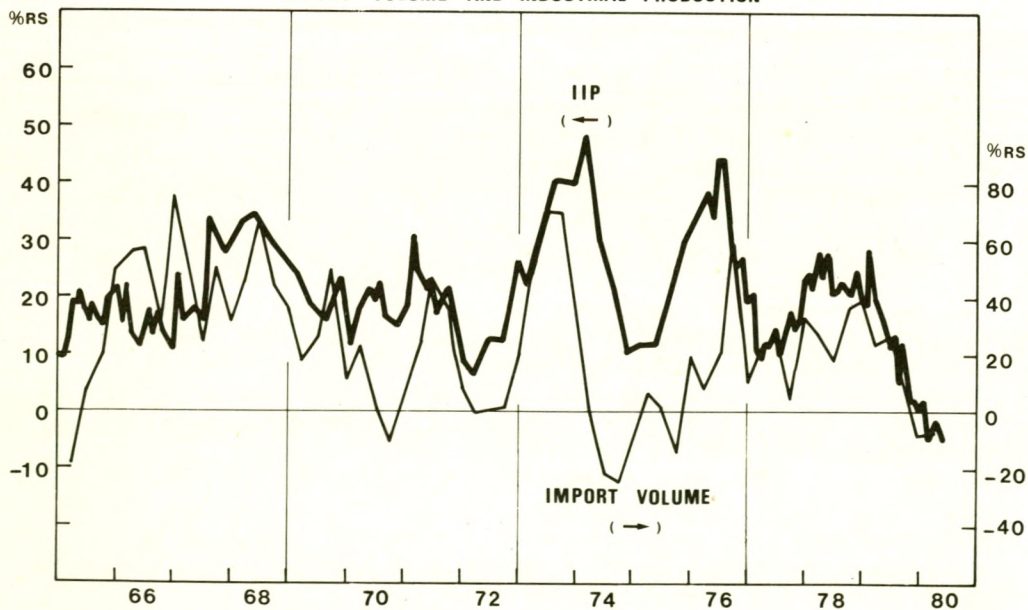
As may be seen from Chart 3, it is likely that any sustainable recovery will require an upturn real purchasing power. In turn this will not occur before the domestic inflation rates fall below the current growth rate of the money supply. However, since the industrial recovery in 1975 preceded the strong upswing in real M_1 (or real purchasing power) in early 1976 one must be careful not to be too categorical. Moreover both the lags in the relation between real purchasing power and industrial production and the strength of the relationship itself are highly variable. For example in 1972-73 there was a clear lead of up to a year

S. KOREA : CHART 3
REAL PURCHASING POWER AND INDUSTRIAL PRODUCTION



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S. KOREA : CHART 4
IMPORT VOLUME AND INDUSTRIAL PRODUCTION



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between what happened to purchasing power, and what happened to industrial production. The same time-lag persisted through the downturn. In 1975 however it seems that it only required real purchasing power to be positive for it to trigger an upturn in activity. In mid-1976 when there was a brief pause in the upswing of real money supply, industrial output faltered, slipping from an admittedly unsustainable level of 40% year-to-year to just 10% within the space of six months. However, the sustained upward movement in real money supply or purchasing power that continued through 1977 appears to have been powerful enough to maintain the momentum of output growth through 1978 and into early 1979.

One obvious reason for not placing too much reliance on this relationship is the importance of exports or foreign demand in determining Korea's level of domestic activity. Both the United States and Japan are major customers for Korea's output of manufactured goods. In 1979 the United States and Japan together accounted for 51.4% of Korea's total exports. Thus one would expect Korean output levels to be significantly affected by the trend of industrial activity and real income growth in these two economies. Thus a contributing factor in the 1975 upturn would have been the almost simultaneous upswing in Japan and the USA, while in the Korean slowdown of 1977 one contributing factor would have been Japan's mini-recession of the same year.

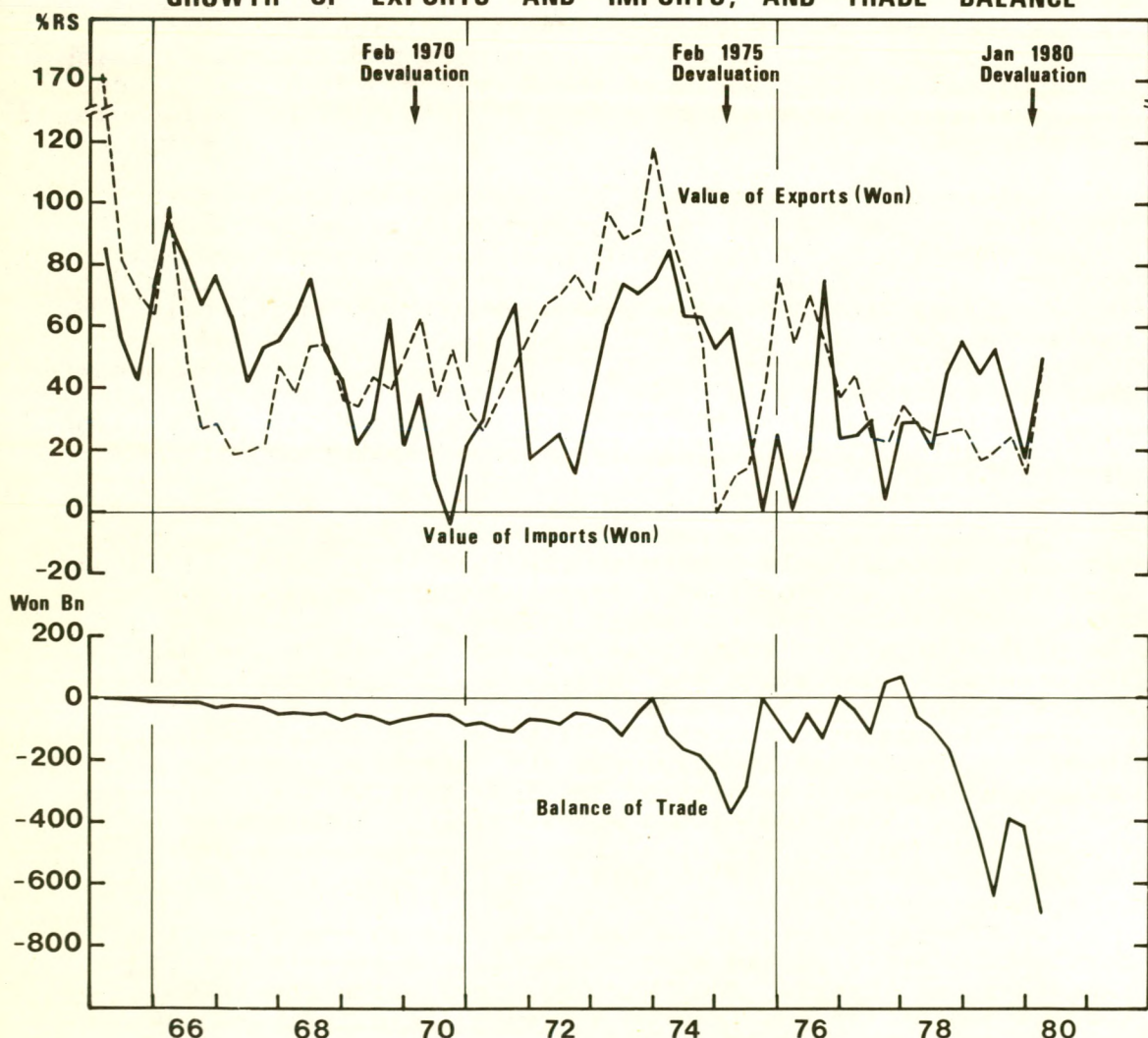
Looking ahead therefore the extent and duration of the recession in the USA and the slowdown in Japan will clearly affect the chances of any improvement in the Korean domestic economic scene. Unless there is a marked improvement in those two economies it is unlikely that a modest upturn in real purchasing power in Korea will be sufficient on its own to ensure a strong recovery. This carries with it the real danger that the acceleration in money growth which the authorities have now legitimated in the June 5th economic programme will be translated into a continuing high rate of inflation with minimal effect on output.

Turning to the external accounts, the volume of imports is evidently very closely linked to the level of industrial output (see Chart 4). The only significant deviations have been in 1970 when the downturn in import volume considerably exceeded the slower growth in industrial production, and in the mid-1970s when the deviation was largely due to changes in import prices. Another temporary deviation occurred in mid-1978. With world commodity prices stabilising, the deviation between these two series has now narrowed and they will probably move very much in line together for the remainder of 1980. However, due to the devaluation of the won it will be some months before the won value of imports stabilises and returns to a profile similar to the volume of imports (see Chart 6).

On the export side it would seem that in won terms the devaluation at first had almost exactly the same impact on exports as on imports (see Chart 5). Following the 1970 devaluation of the won imports slowed quite quickly so that

within a year they actually showed an absolute decline in value. However the devaluation produced no detectable long term effect on the trade balance, only a temporary improvement. Moreover this was a devaluation which was succeeded by a more restrictive monetary policy (see the slowdown in M_1 growth in Chart 1 from 1970 to 1971) rather than an expansionary policy such as is being pursued today. After the 1975 devaluation the impact on imports took longer to show through, and it was not until late 1975 and early 1976 that exports substantially outperformed imports, thus restoring the trade balance from a 400 billion won deficit to near-balance (Chart 5). This time with worldwide economic conditions approximating more closely to the recession of 1974-75 than to the conditions of 1970, and following Korea's import liberalisation in 1978, it is probable that January's devaluation would have taken some time to affect the trade accounts favourably. Under the more stimulatory

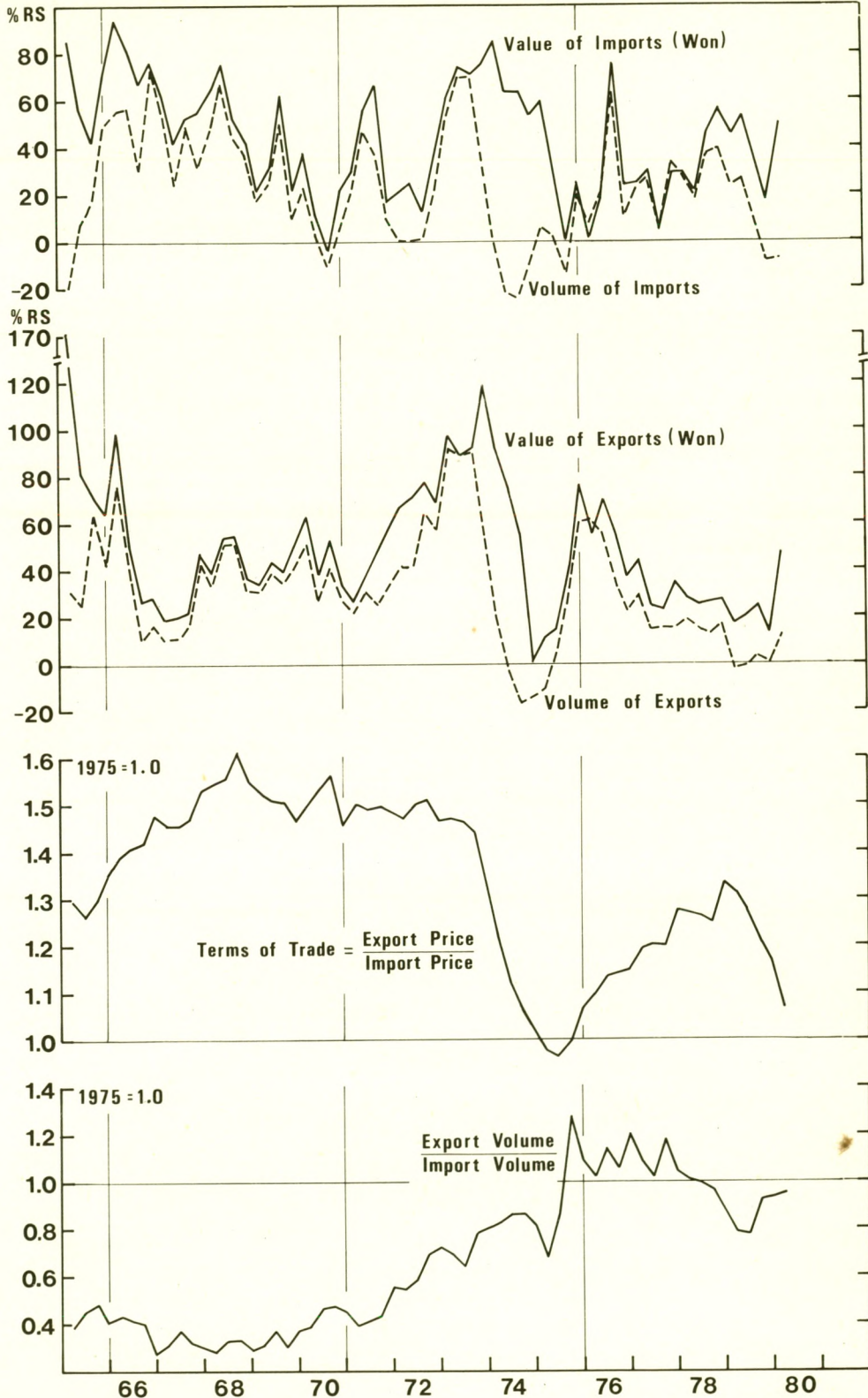
**S. KOREA : CHART 5
GROWTH OF EXPORTS AND IMPORTS, AND TRADE BALANCE**



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S. KOREA : CHART 6

VALUE AND VOLUME GROWTH, AND TERMS OF TRADE



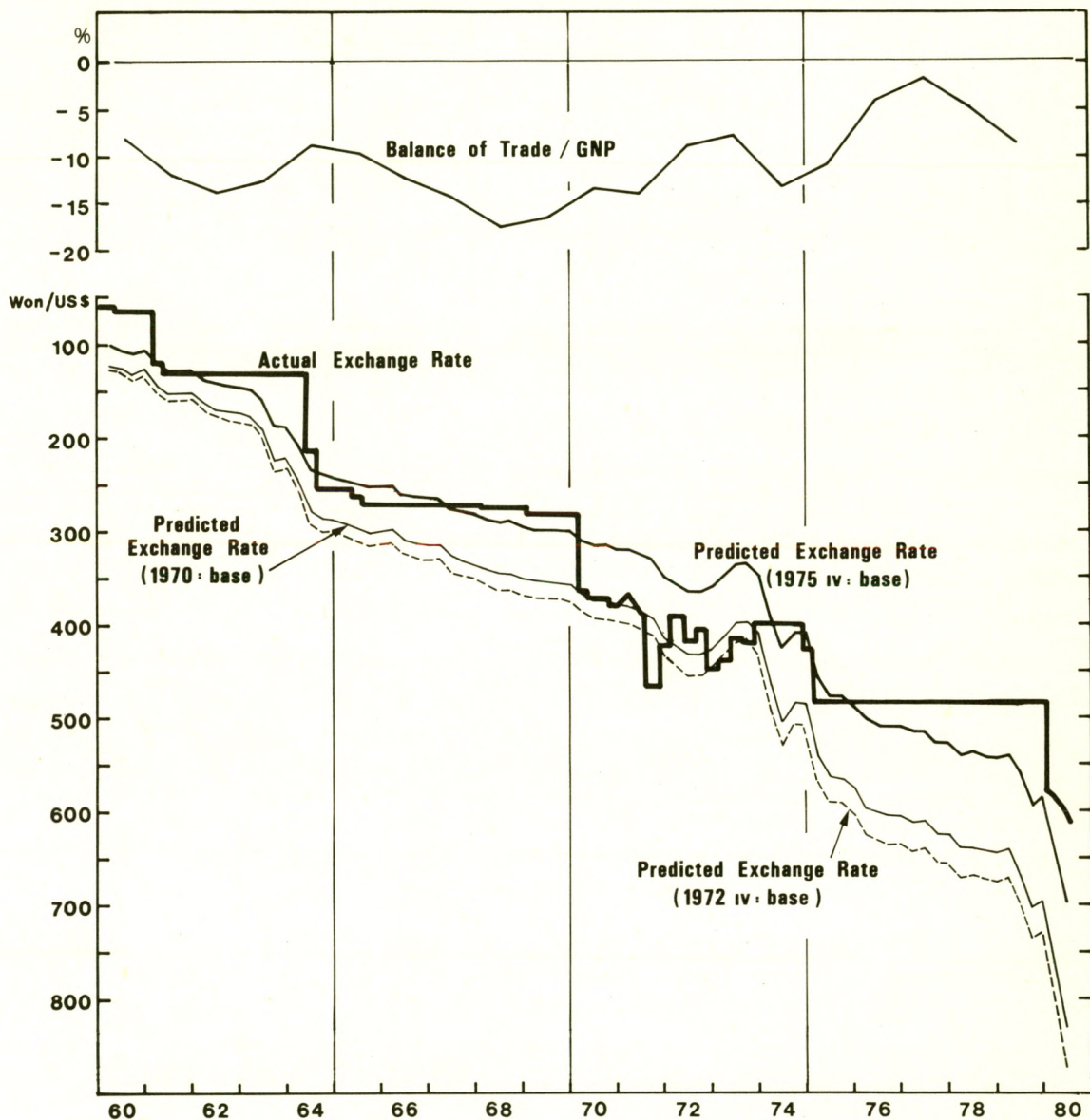
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policy laid down by the June 5th economic programme, those favourable effects are likely to be even further postponed because of the difficulty Korea will experience in bringing down its domestic inflation.

FORECAST: The Korean authorities have taken a bold gamble. They are hoping that the combination of the January devaluation and the stimulatory programme of June 5th will enable the economy to enjoy an export-led recovery which will restore health to the balance of payments. However, economic conditions in today's world and the experience of the past two devaluations suggest that there is little chance of this happening. For the devaluation to be successful, past history suggests that monetary policy should be tightened rather than eased in its aftermath. Unfortunately, the deliberate easing of policy in June is likely to undo the possible good effects of the January devaluation. Korea is therefore faced with the prospect of continuing balance of payments weakness and the prospect of continuing high inflation through the remainder of 1980.

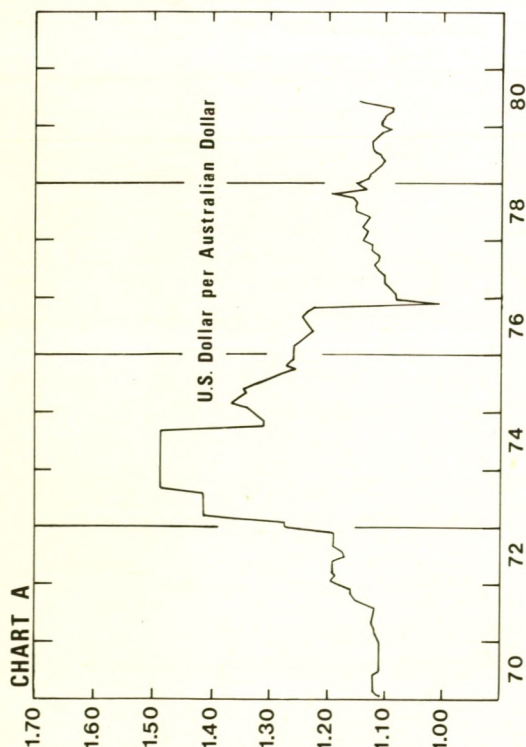
SOUTH KOREA

CHART 7 : ACTUAL AND PREDICTED EXCHANGE RATES



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AUSTRALIAN DOLLAR



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Changes in the value of the Australian dollar against the US dollar during the last six months have been broadly coincident with the movements in the Australian-US dollar interest rate differential, as may be seen from a comparison of charts A and C. From a rate of A\$1 = US\$1.1072 in early February the Australian currency weakened to A\$1 = US\$1.0853 as Eurodollar rates rose to a cyclical high in March. The Australian dollar subsequently strengthened above its previous high to reach A\$1 = US\$1.1558 as US rates declined.

Although the trade weighted value of the Australian dollar has remained relatively stable recently - indicating that current A\$/US\$ rate is primarily a reflection of relative US\$ weakness - it has been suggested by some commentators that the A\$ is still undervalued. The reasons proposed for this view include Australia's large trade surplus and the improvement in its current account during 1979 (see chart B), the prospect of large capital inflows in 1981 and 1982 to finance raw material exploitation, and the improvement in Australia's external competitiveness as a result of favourable relative inflation rates during 1979, after several years when the A\$ would appear to have been overvalued on a relative price basis (see chart D).

However, chart E shows that by partially insulating itself from

the rise in US rates during the first quarter of 1980, Australia has effectively avoided an economic slowdown at the expense of steady increase in the money supply, and then inflation. With both aggregate demand and inflation in Australia's trading partners in the coming year likely to decline the recent improvement in external competitiveness and in the trade account will be reversed.

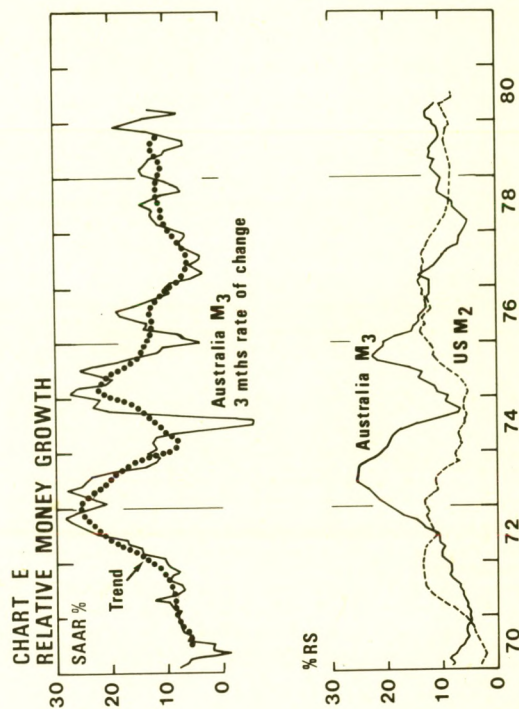
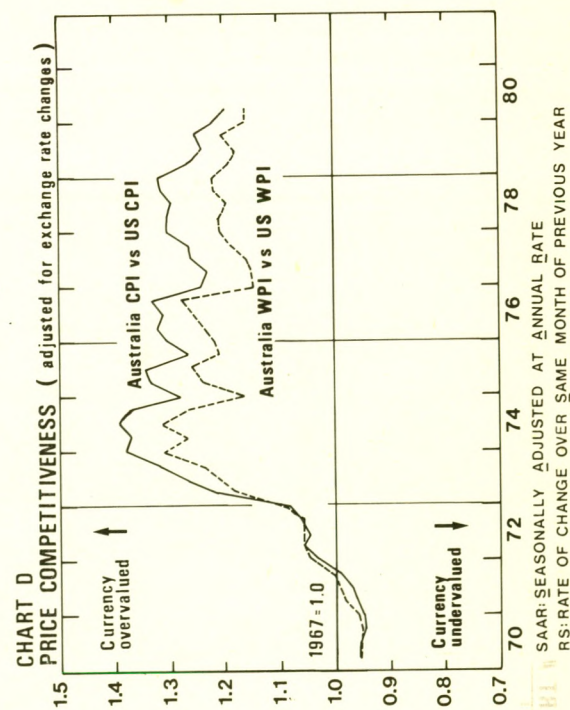
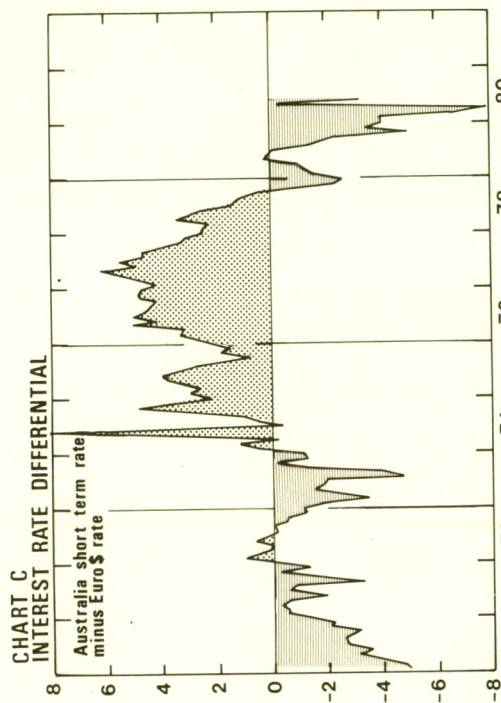
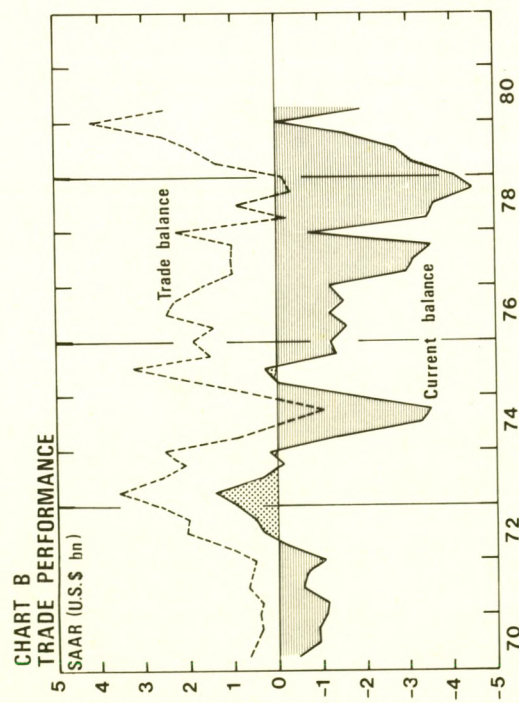
In previous business cycles a weaker current account position has tended to weaken the external value of the Australian dollar. Certainly an increased current account deficit has never presaged a stronger Australian currency. Two things however would allow the A\$ to appreciate against the dollar. First US interest rates could begin declining once again. The A\$ would then appreciate during a period of general US\$ weakness. Given that the US monetary aggregates are now back within target, and that there are some signs that the economy is recovering, this is unlikely. Second, Australia's capital account could strengthen irrespective of changes in interest rate differentials as a consequence of strong private capital inflows. The timing of these inflows is difficult to predict but, at least over the next six months, such inflows are best regarded as a fortuitous way of offsetting any slight weakness in the A\$.

The A\$/US\$ rate is likely to continue to be predominantly determined by interest rate differentials during the remainder of the third quarter and this is likely to lead to the A\$ trading at a slightly lower level against the US\$. In the latter part of the year it is possible that a deterioration in both Australia's price competitiveness and current account will put further downward pressure on the A\$. Higher capital inflows to finance resource development will offset this, but in the absence of such inflows the A\$ has a tendency towards slight weakness.

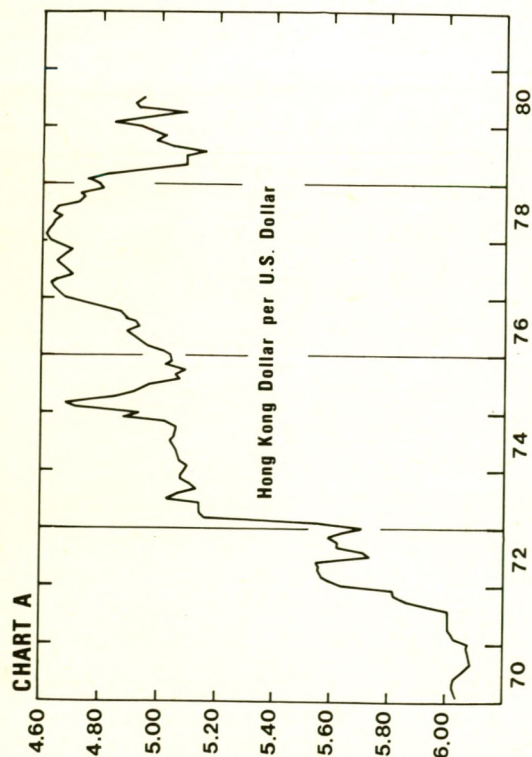
A\$/US\$	FORECAST A	Actual Range	Actual				Forecast	
			1980	Q1	Q2	Q3	Q4	
			1.0825	1.1175	1.0715-1.1580	1.12-1.16	1.10-1.14	
						1.14-1.18	1.16-1.22	

Forecast A assumes US interest rates remain at current levels (end July) or rise.

Forecast B assumes US interest rates decline.



HONG KONG DOLLAR



As with many other currencies in the Asian Pacific Region movements in the US\$/HK\$ exchange rate during 1980 have been predominantly determined by the change in interest rate differentials. However, although the Hong Kong dollar is supposedly a freely floating currency its exchange rate relative to the US dollar has been more stable than other currencies.

The most notable feature of Hong Kong's current economic circumstances is the very rapid growth in M3 (see Chart E) experienced during the past year. The annualised three monthly growth is now rising well above the longer run trend indicating that this increase in liquidity is accelerating. As explained in many previous editions of AMM, there are no effective institutional arrangements that are likely to bring about a reversal in this trend so the money supply will most probably continue to grow at a rapid rate.

Rising liquidity growth makes it likely that the Hong Kong economy will continue to expand at close to current levels. It is therefore very improbable that Hong Kong's consumer price will decline (in contrast to official projections), and with many of the major economies slowing down we would expect both Hong Kong's external competitiveness and trade balance to come under pressure.

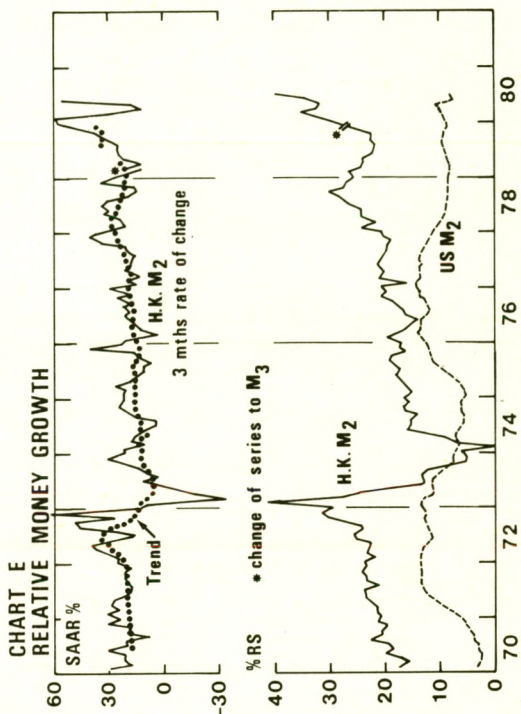
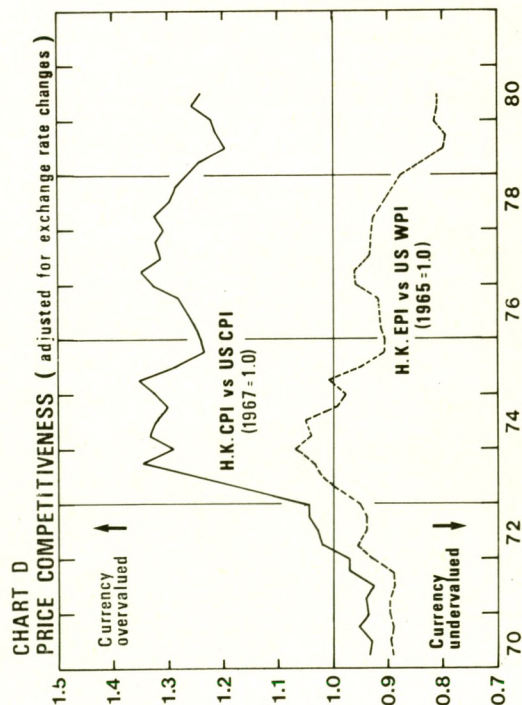
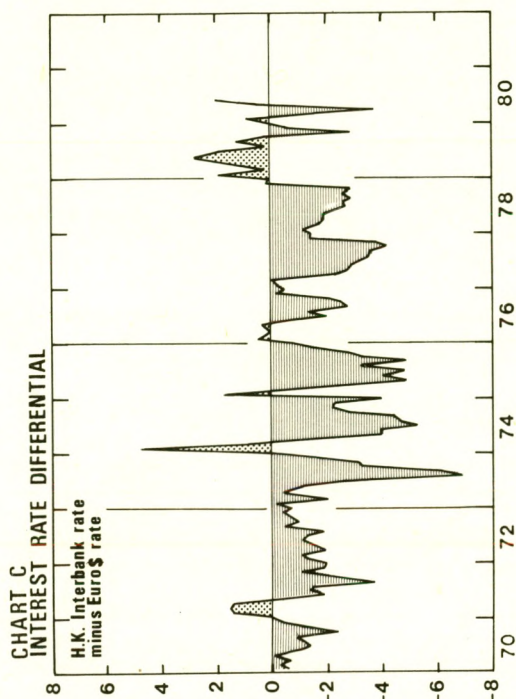
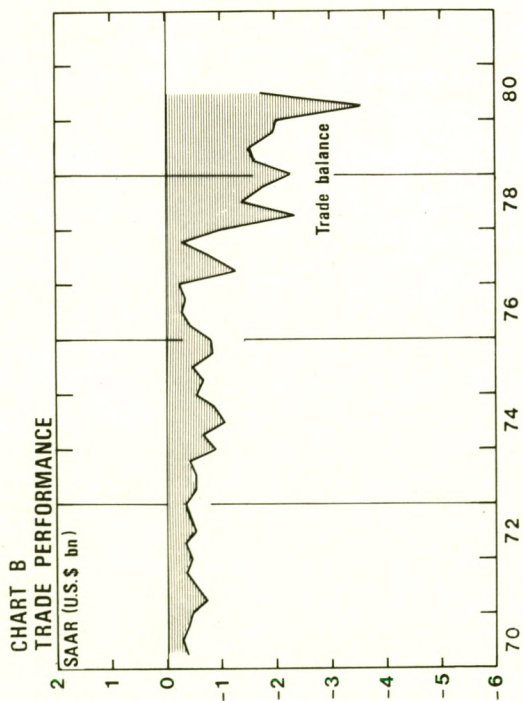
Typically, such a combination of circumstances would lead to currency weakness, but as may be seen from a comparison of charts A, B, D and E the HK\$/US\$ exchange rate is not particularly sensitive to changes in these variables. This makes it more than usually difficult to make predictions concerning the HK\$/US\$ rate. For example, a comparison of Hong Kong and US consumer prices would indicate that the Hong Kong dollar has been consistently overvalued for several years (Chart D) but the Hong Kong dollar has not indicated any tendency to weaken during this period.

One important influence which is not quantified in these charts is the inflow of foreign capital - rumoured to be substantial - to Hong Kong. This coupled with the recent reduction in the trade deficit has probably been a stabilising factor in the HK\$/US\$ exchange rate. It is therefore perhaps unlikely, despite the fundamental prospects for inflationary growth in the economy, that the Hong Kong dollar will undergo particularly large or rapid movements for the remainder of this year.

US\$/HK\$	Actual		Forecast	
	1980	Q1	Q2	Q3
FORECAST A				
Actual Range	4.78-5.08		4.87-5.10	4.92-5.00
FORECAST B				
			4.88-4.94	4.85-4.90

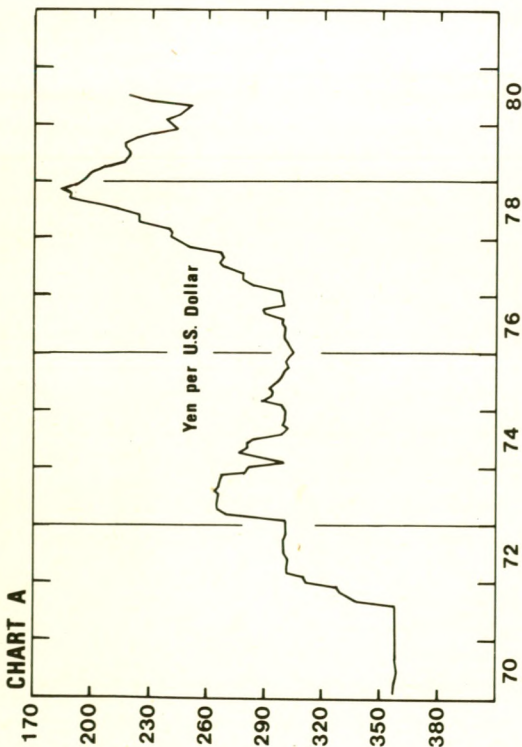
Forecast A assumes US interest rates will remain at current (end-July) levels, or rise.

Forecast B assumes US interest rate will decline.



EPI : EXPORT PRICE INDEX
SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

JAPANESE YEN



Japan has been highly competitive since mid-1979 on the basis of relative prices adjusted for exchange rate changes (see Chart D). Despite the turning point reached in March this year, the yen still remains somewhat undervalued. This very satisfactory price competitive performance has been undermined by continuing weakness in the Japanese trade and current account balance, but both of these could now be approaching a turning point (see Chart B) as the Japanese economy slows and as the USA shows some signs of recovery. Compared with the deterioration in Japan's trade position after the first oil crisis of 1973-74 the present deterioration has been much more severe even though the domestic economy is evidently less overheated. Because much more of the strain has been taken on the exchange rate, there has been very little change in monetary policy (Chart E). Whereas in 1973 and 1974 domestic monetary policy was tightened sharply, bringing Japan's M_2 growth from over 25% to almost 10% on a year-to-year basis, this time the deceleration has been much more modest, with M_2 growth slowing from 13% to just below 10%.

The most dramatic change recently, and the one which accounts for most of the movement in the ¥/\$ rate is the closing of interest rate differentials shown in Chart C. The gap between Japan's 3-month gonsaki (bond repurchase) rate and 3-month Eurodollar rates has closed

from 8.5% in favour of Euro\$ rates to almost 2.5% in favour of Japanese domestic rates. For some months now interest rate differentials have dominated the foreign exchange markets, and while major central banks are pursuing restrictive policies this is likely to remain the case. A pause in the downward movement of US rates, or even some upturn, together with a weakening in Japan's short-term rates as the economy slows towards year-end will make the yen vulnerable to some weakness.

As the forecast indicates, the extent of yen weakness depends considerably on the magnitude of interest rate movements. In order to keep U.S. monetary growth within its targeted ranges the U.S. Federal Reserve System will probably have to maintain interest rates at around their current 10% levels for several months until further weakness in economic activity or a fall in the inflation rate permits interest rates to fall. Irrespective of the Fed's policy, the Bank of Japan will probably continue with its strict quantitative controls over M_2 +CDs, though it may allow interest rates in Japan to decline as the Japanese economy slows. However, even with a modest decline in interest rates in Japan and higher interest rates in the U.S. the turnaround in Japan's trade position and its continuing price competitiveness mean that the yen is most unlikely to decline below ¥235 per U.S. dollar. This is because a slowdown in Japan is capable of producing a more pronounced improvement in the yen than even the sharp U.S. recession has achieved for the dollar.

¥/US\$	Actual			Forecast	
	1980	Q1	Q2	Q3	Q4
FORECAST A					
Actual Range		233.80-249.80	215.40-260.70	220-230	225-235
FORECAST B				205-220	195-210

Forecast A assumes that US interest rates remain at current (end-July) levels, or rise.

Forecast B assumes that US interest rates will decline.

CHART B
TRADE PERFORMANCE

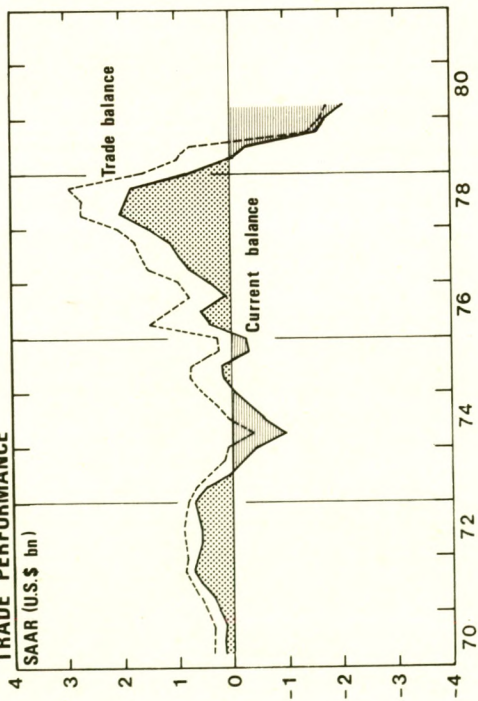


CHART C
INTEREST RATE DIFFERENTIAL

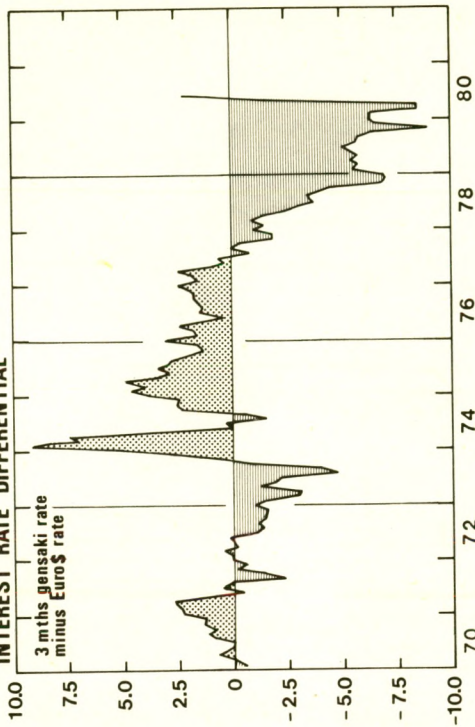


CHART D
PRICE COMPETITIVENESS (adjusted for exchange rate changes)

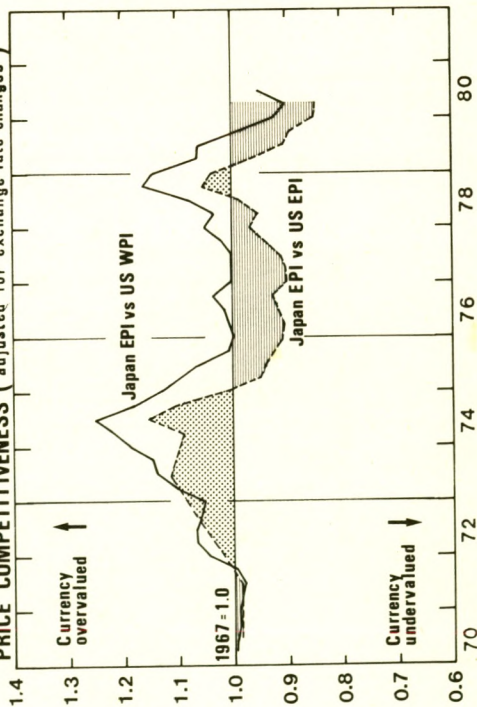
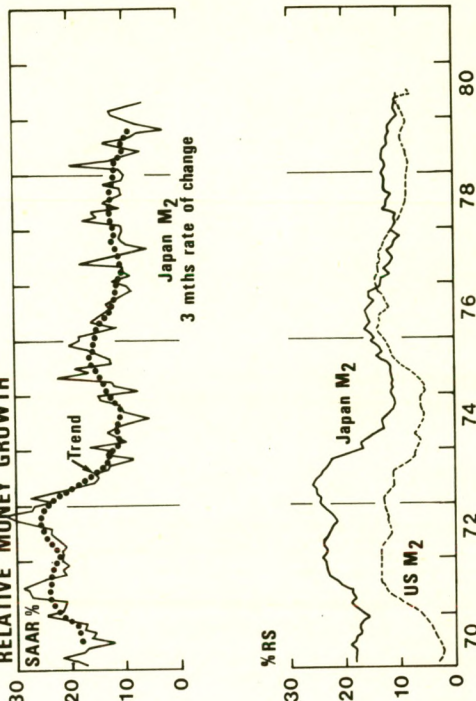
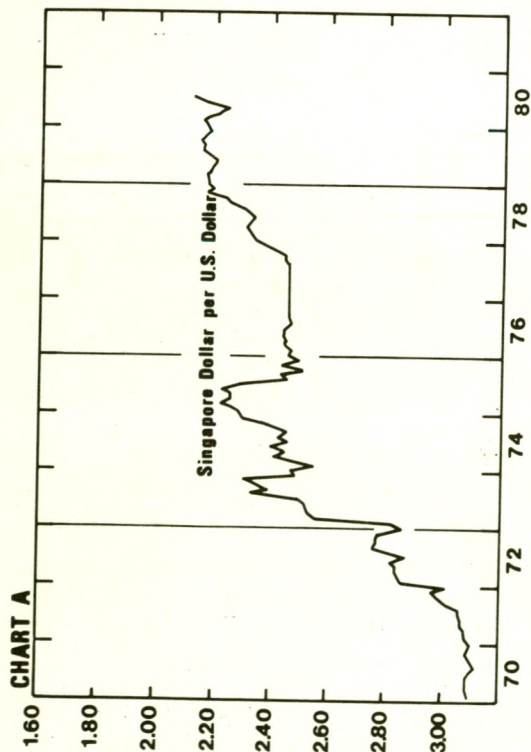


CHART E
RELATIVE MONEY GROWTH



EPI: EXPORT PRICE INDEX
SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

SINGAPORE DOLLAR



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The Singapore dollar is a managed currency. The Monetary Authority of Singapore (MAS) regulates the value of the Singapore dollar by intervening in the foreign exchange market, using the US\$ as the intervention currency. The currency is managed against an index or 'basket' of other currencies, to keep the value of the S\$ approximately "stable" vis-a-vis the index. The exact composition of the basket is not disclosed, but since the management of the currency is discretionary rather than mechanistic, the exact composition is not of crucial significance.

In 1977-78 when the S\$ became undervalued vis-a-vis the US\$ because inflation in Singapore was lower than in the USA (Chart D), the MAS began deliberately to move the S\$ upwards against the US currency (Chart A). Between June 1977 and December 1978 the appreciation was 13.2%. The effect of this appreciation was to limit the improvement in the balance of trade which had begun in 1975 (Chart B), and hence to restrict the overall balance of payments surplus. This in turn enabled the MAS to restrain monetary growth through 1977, 1978, and into 1979 (Chart E).

However since September 1979 there has been a sudden surge in money growth, the origins of which were discussed in the last

issue of AMM. On a 3-month annualised basis this acceleration is even greater than the episode of 1972-73, both on an absolute basis and relative to the USA. On these grounds alone one should be alert to the possibility of S\$ weakness in the months ahead. When the narrowing of interest rate differentials (Chart C) is added, the forecast is for rather more weakening if US rates actually rise. However, the point of maximum weakness for the S\$ is unlikely to be as low as its April trough of S\$2.3010 because not only will the MAS be trying to rein in on money growth by keeping interest rates above US rates, but Singapore's price competitiveness will provide some floor against any steep depreciation.

Actual Forecast

S\$/US\$	1980 : Q1	Q2	Q3	Q4
FORECAST A				
Actual Range	2.2540-2.1502	2.3010-2.1165	2.19-2.13	2.17-2.25
FORECAST B			2.16-2.12	2.15-2.10

Forecast A assumes US interest rates will remain at current (end-July) levels, or rise.

Forecast B assumes US interest rate will decline.

CHART B

TRADE PERFORMANCE

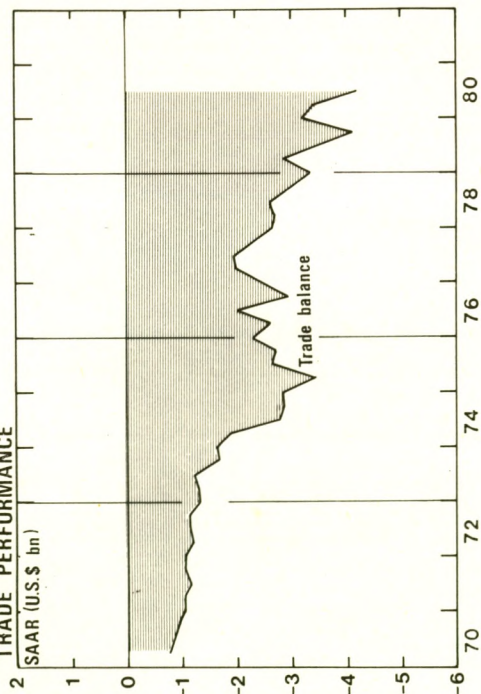


CHART C

INTEREST RATE DIFFERENTIAL

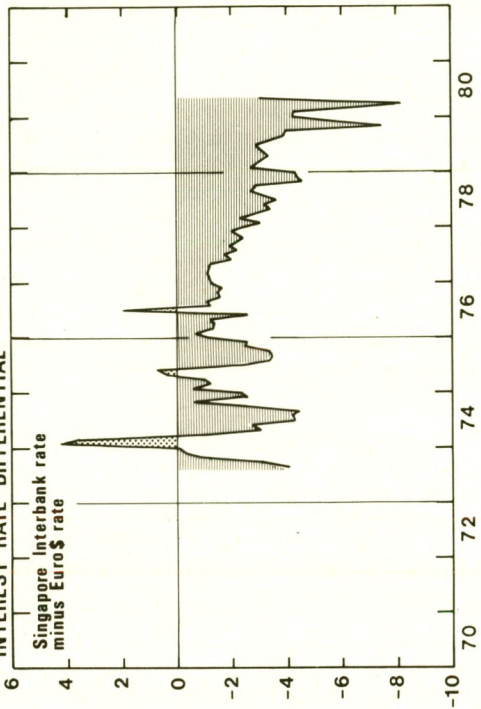


CHART D

PRICE COMPETITIVENESS

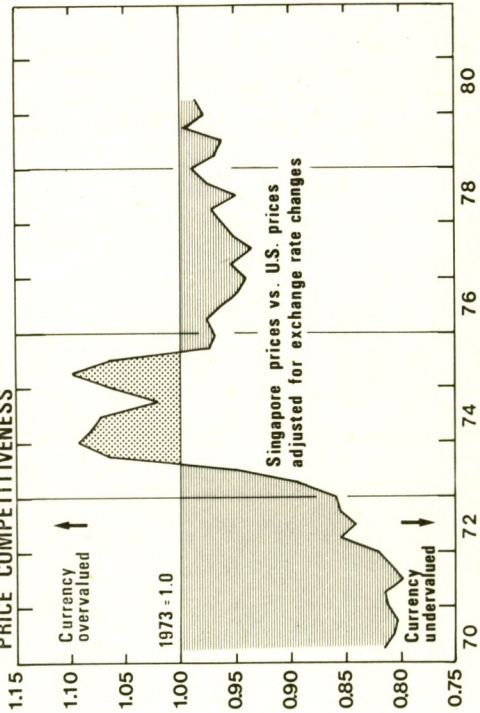
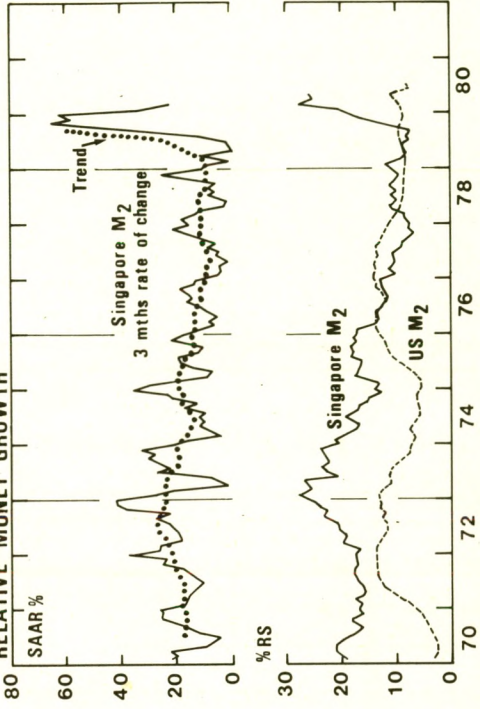


CHART E

RELATIVE MONEY GROWTH



EXPORT GROWTH RATES (in US \$ terms) OF 11 ASIAN PACIFIC RIM ECONOMIES (Year - to - Year Percentage Changes)

COUNTRY	JAPAN	HONG KONG	SINGAPORE	MALAYSIA	AUSTRALIA	NEW ZEALAND	S. KOREA	TAIWAN	PHILIPPINES	THAILAND	INDONESIA
DATE											
1975. Q1	27.7	-8.1	-8.0	-15.8	17.4	-30.5	-12.0	-7.4	3.3	-17.7	0.5
Q2	-0.4	-12.5	-11.5	-17.3	16.0	-9.4	-7.1	-11.6	-17.6	-21.2	-17.9
Q3	-8.2	2.5	-12.9	-11.9	4.2	-11.8	12.9	-7.2	-12.6	-1.4	-8.9
Q4	-8.1	23.0	2.0	6.2	0.8	-9.5	52.4	18.8	-27.7	3.8	9.2
1976. Q1	9.3	40.1	16.0	20.8	0.3	25.5	60.9	46.8	-16.7	18.4	0.0
Q2	20.0	46.5	13.8	37.2	4.8	31.8	71.7	51.9	18.4	43.2	39.0
Q3	27.1	40.3	33.1	51.3	24.0	27.7	58.4	70.6	26.6	31.8	28.7
Q4	25.0	40.2	27.9	43.5	6.9	27.6	39.9	45.9	19.6	49.2	15.6
1977. Q1	23.4	13.9	26.5	32.8	6.9	32.8	44.2	7.2	37.7	26.3	47.9
Q2	20.7	12.8	27.8	19.0	2.5	14.1	23.8	21.9	17.2	24.3	25.8
Q3	17.9	13.5	25.9	15.0	-7.5	16.2	22.8	9.0	12.1	21.6	25.3
Q4	18.7	11.2	18.7	-0.3	12.8	3.0	33.9	20.4	30.3	-1.1	14.1
1978. Jan	19.5	3.1	16.9	9.5	9.0		20.5		8.6	8.9	
Feb	26.8	0.2	14.5	-1.6	8.2	10.3	31.5	27.4	4.6	12.4	16.0
Mar	22.6	24.5	24.4	3.0	2.9		32.3		-2.5	0.7	
Apr	14.5	21.4	22.2	15.1	1.5		28.7		11.5	-2.7	
May	26.7	20.8	16.9	15.7	3.7	4.4	27.0	39.0	4.0	16.7	1.5
Jun	21.6	19.1	19.0	10.2	18.1		18.6		-3.7	14.5	
Jul	15.0	7.2	13.3	9.3	13.2	1.9	25.4	41.4	16.8	0.4	-16.0
Aug	23.5	23.6	24.2	26.4	-0.3	21.5	21.2	47.0	12.1	8.2	-3.3
Sep	31.2	28.0	27.5	32.7	-3.3	23.9	32.1	46.1	31.0	27.4	-9.3
Oct	20.9	32.1	31.9	47.6	24.8	50.0	73.3	38.3	4.7	38.6	19.3
Nov	21.3	28.3	29.2	46.9	8.9	79.4	26.5	31.2	11.7	55.2	11.0
Dec	13.3	16.9	32.3	44.3	10.6	9.9	2.6	23.2	14.7	32.8	38.0

COUNTRY	JAPAN	HONG KONG	SINGAPORE	MALAYSIA	AUSTRALIA	N. ZEALAND	S. KOREA	TAIWAN	PHILIPPINES	THAILAND	INDONESIA
DATE											
1979. Jan	7.5	38.0	28.1	47.6	29.1	31.5	8.6	28.0	-1.9	30.6	-5.2
Feb	4.7	56.3	47.2	63.6	17.3	28.0	21.7	63.5	38.5	40.5	-11.4
Mar	7.7	30.7	23.7	53.3	19.2	36.7	20.6	36.0	35.6	31.7	41.0
Apr	1.1	29.3	25.4	55.6	19.9	11.1	12.3	25.7	34.0	49.7	8.7e
May	6.3	25.5	52.3	48.9	41.3	77.2	26.2	4.6	32.4	24.4	8.7e
Jun	7.0	31.0	34.4	75.4	21.5	11.5	20.6	34.8	52.7	21.8	42.0
Jul	6.7	36.8	56.1	54.3	28.4	18.6	23.1	21.6	29.8	26.3	132.2
Aug	3.2	35.6	47.5	48.0	22.5	27.6	26.9	21.8	27.5	37.9	55.5
Sep	4.8	36.0	37.4	52.9	43.9	28.7	23.1	38.4	39.1	18.3	65.7
Oct	4.8	33.0	39.5	42.0	35.2	14.3	11.5	31.3	45.2	33.6	20.1
Nov	2.3	36.9	41.6	28.4	34.1	13.6	18.6	18.4	30.4	22.0	52.6
Dec	11.7	31.9	50.7	38.6	37.5	35.2	10.3	17.1	30.8	29.0	35.9
1980. Jan	14.9	34.8	61.9	48.8	30.0	12.7	25.8	49.7	74.4	53.9	
Feb	23.4	21.8	59.9		41.1	25.2	25.8	24.1	37.9	42.1	
Mar	13.5	22.7	45.0		36.4	16.7	16.8		37.2	48.4	
Apr	26.6	38.5	44.4		28.7	16.1	18.3			22.7	
May	27.0	41.8	41.5		4.4	17.4	16.6	31.9		29.3	
Jun	26.9	37.5	50.0		31.9						
Jul	28.5	29.8					9.5				

IMPORT GROWTH RATES (in US \$ terms) OF 11 ASIAN PACIFIC RIM ECONOMIES (Year - to - Year Percentage Changes)

COUNTRY	JAPAN	HONG KONG	SINGAPORE	MALAYSIA	AUSTRALIA	N. ZEALAND	S. KOREA	TAIWAN	PHILIPPINES	THAILAND	INDONESIA
DATE											
1975. Q1	3.6	-7.2	14.8	-0.2	9.9	21.8	31.1	8.7	29.1	0.9	104.7
Q2	-9.4	-18.1	-9.6	-16.8	-9.2	-13.7	6.4	-33.5	3.7	6.7	13.0
Q3	-9.0	1.7	-10.4	-22.6	-20.5	-31.6	-17.4	-23.5	-5.5	3.8	16.2
Q4	-5.6	26.6	-5.0	-15.3	-13.1	-22.1	9.7	6.2	3.3	2.7	4.8
1976. Q1	2.5	32.7	-0.2	-1.8	6.5	-2.9	-4.1	21.3	16.1	12.7	-8.8
Q2	11.0	39.8	1.3	3.1	9.2	-5.6	12.3	36.3	-0.1	-0.6	3.9
Q3	18.3	28.0	24.6	19.9	19.7	13.6	66.3	34.4	1.6	5.2	34.7
Q4	16.1	27.3	22.2	22.5	7.2	5.8	17.9	19.3	14.9	20.1	54.5
1977. Q1	16.9	22.7	11.1	18.2	14.2	-1.3	26.8	9.4	2.8	22.8	31.9
Q2	12.1	18.6	20.8	19.8	15.2	14.0	31.6	21.7	16.0	28.0	15.1
Q3	5.1	12.3	12.1	12.4	5.0	13.5	6.0	6.1	14.6	39.7	-7.5
Q4	4.1	17.5	16.0	17.5	11.0	-6.0	30.9	12.2	5.0	26.4	8.5
1978. Jan	6.1	13.1	22.8	21.6	16.3		30.5		-12.2	24.5	
Feb	10.1	16.4	20.1	16.2	-3.5	-7.1	35.9	20.8	4.4	2.0	-1.9
Mar	-0.4	24.2	23.4	22.2	2.7		23.4		17.5	22.8	
Apr	8.7	20.6	17.7	13.6	4.2		20.1		18.6	20.2	
May	15.7	22.0	23.9	22.7	7.1	-3.9	31.6	22.6	9.1	19.2	35.4
Jun	-1.5	29.0	25.6	35.0	8.3		12.2		16.0	21.2	
Jul	9.1	19.4	29.3	48.9	15.3	-12.0	49.0	34.7	19.2	3.0	10.8
Aug	12.0	37.4	18.3	29.6	17.1	9.0	45.3	42.3	29.4	6.3	-13.2
Sep	19.0	45.1	22.0	24.8	15.6	-6.1	45.6	39.1	13.0	12.1	22.0
Oct	20.5	30.3	34.8	40.4	27.3	58.1	56.3	34.0	25.5	14.1	-14.3
Nov	23.8	44.3	35.9	40.4	38.5	29.3	60.4	41.3	38.5	30.0	-5.2
Dec	21.4	33.5	20.0	19.6	36.1	5.7	50.5	30.1	27.0	18.4	2.5

COUNTRY	JAPAN	HONG KONG	SINGAPORE	MALAYSIA	AUSTRALIA	N. ZEALAND	S. KOREA	TAIWAN	PHILIPPINES	THAILAND	INDONESIA
DATE											
1979.											
Jan	25.6	21.1	13.4	23.1	23.0	43.1	36.2	21.7	68.6	28.8	-16.7
Feb	27.9	37.2	41.9	47.3	21.2	25.9	52.2	68.2	39.7	46.8	1.6
Mar	33.5	24.3	25.7	12.0	15.7	13.5	46.7	38.5	29.8	19.7	11.7
Apr	32.9	30.5	35.7	40.3	21.9	38.9	43.2	23.8	21.6	36.8	-27.1e
May	25.9	24.7	39.3	33.9	26.5	55.9	60.9	32.2	42.2	24.9	-27.1e
Jun	46.4	24.4	33.2	30.5	26.7	28.7	53.8	43.2	41.3	32.1	45.1
Jul	45.1	34.8	31.3	13.6	13.8	34.4	35.6	23.7	48.0	44.1	-13.3
Aug	46.4	31.1	56.6	25.6	14.3	30.0	38.8	38.5	13.3	45.0	20.6
Sep	47.8	32.3	46.1	48.2	10.5	36.6	25.6	39.1	55.7	24.2	19.5
Oct	46.9	39.5	21.3	36.5	15.7	12.4	12.8	49.2	37.2	53.1	19.3
Nov	47.8	23.9	36.5	29.0	9.3	24.2	13.9	16.8	9.2	30.1	48.0
Dec	43.4	18.9	43.4	54.0	9.1	36.4	25.3	24.9	22.8	22.1	30.5
1980.											
Jan	38.6	50.0	58.9	50.7	30.8	22.0	24.9	58.5	24.9	31.4	
Feb	48.3	23.9	34.2		35.6	53.9	28.6	15.3	40.9	43.2	
Mar	38.9	34.2	50.4		13.4	39.1	20.1		24.9	33.8	
Apr	44.7	38.7	38.4		12.2	16.5	22.2			23.3	
May	36.2	42.3	48.6		14.1	6.0	- 2.5	46.0		30.0	
Jun	42.5	30.5	34.7		11.8						
Jul	35.6	27.0						47.8			

TRADE BALANCES (in US \$_M) OF 11 ASIAN PACIFIC RIM ECONOMIES

COUNTRY	JAPAN	HONG KONG	SINGAPORE	MALAYSIA	AUSTRALIA	N. ZEALAND	S. KOREA	TAIWAN	PHILIPPINES	THAILAND	INDONESIA
DATE											
1975. Q1	-1279	-191	-863	7	415	-377	-996	-188	-204	-132	561
Q2	-635	-181	-659	-7	658	-179	-800	-96	-258	-396	375
Q3	-407	-114	-677	57	484	-196	-166	-183	-313	-299	559
Q4	221	-251	-570	181	382	-237	-368	-190	-333	-244	898
1976. Q1	-411	-153	-654	213	261	-230	-380	72	-435	-115	663
Q2	521	-160	-496	300	582	64	-99	63	-149	-176	956
Q3	716	57	-733	363	707	-153	-380	233	-182	-170	647
Q4	1603	-101	-613	446	400	-130	-86	185	-287	-132	607
1977. Q1	457	-346	-496	411	84	-22	-233	42	-220	-115	1149
Q2	1856	-309	-489	351	255	74	-434	81	-165	-253	1341
Q3	2995	92	-585	445	279	-157	-51	311	-225	-368	1341
Q4	4433	-267	-660	252	501	-59	-46	393	-140	-397	790
1978. Jan	-333	-149	-296	87	37	25	-165	51	-60	-87	557
Feb	1639	-218	-237	101	112	52	-112	49	-60	-21	717
Mar	2419	-224	-138	65	-17	41	-47	72	-110	-115	310
Apr	1597	-199	-195	123	128	103	-89	92	-83	-128	168
May	589	-113	-194	92	24	-15	-193	251	-92	-153	315
Jun	2351	-150	-267	71	156	60	-151	132	-125	-118	378
Jul	2054	-117	-322	76	17	33	-165	225	-77	-113	120
Aug	1246	-6	-193	165	-110	-56	-296	167	-143	-154	460
Sep	2088	-120	-235	169	-44	-4	-136	189	-61	-87	424
Oct	1489	-119	-370	151	-73	-77	-148	197	-133	-110	638
Nov	1089	-258	-268	176	-3	40	-474	38	-129	-92	258
Dec	1972	-268	-199	209	73	44	-284	166	-85	-99	607

COUNTRY	JAPAN	HONG KONG	SINGAPORE	MALAYSIA	AUSTRALIA	N. ZEALAND	S. KOREA	TAIWAN	PHILIPPINES	THAILAND	INDONESIA
DATE											
1979.											
Jan	-1456	-48	-227	233	116	6	-438	114	-254	-109	582
Feb	363	-387	-300	221	93	72	-420	50	-86	-48	585
Mar	951	-224	-191	301	18	120	-342	79	-127	-96	590
Apr	-395	-270	-350	257	133	49	-438	132	-68	-137	523e
May	-800	-133	-172	208	205	29	-662	11	-160	-193	523e
Jun	240	-124	-341	341	130	10	-583	100	-146	-191	520
Jul	-235	-139	-220	340	199	1	-353	253	-170	-216	1174
Aug	-1673	43	-386	365	-27	-80	-536	28	-118	-250	882
Sep	-749	-120	-422	282	312	-27	-201	255	-147	-130	925
Oct	-1407	-235	-280	247	178	-80	-185	94	-159	-232	771
Nov	-2214	-180	-314	223	337	10	-489	63	-76	-155	423
Dec	-266	169	-215	207	436	56	-566	109	-78	-95	855
1980.											
Jan	-3453	-255	-329	336	139	-24	-543	87	-212	-48	
Feb	-1399	-244	-174		196	-2	-569	157	-131	-75	
Mar	-1080	-426	-346		318	70	-456		-114	-62	
Apr	-2005	-376	-422		375	55	-579			-171	
May	-1850	-196	-339		74	80	-402	-150		-255	
Jun	-1018	-74	-294		460						
Jul	-952	-138						-202			



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EDITORS:

John G. Greenwood

M.A. (Hons) Econ. Edinburgh
Research Economist, University of Tokyo
Economist at G.T. Management (Asia) Ltd.

Christian Wignall

B.A. Econ. Cambridge
Economist at G.T. Management (Asia) Ltd.

Hugh Sloane

B.A. Econ. Bristol
M. Phil. Econ. Oxford
Economist at G.T. Management (Asia) Ltd.

**CHARTS AND
STATISTICS:**

S.Y. Chan
Michael Wong

ADMINISTRATION:

Isabella L.Y. Ling

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KEY TO SYMBOLS USED IN THE CHARTS

% RP - Percentage Rate of change over Preceding period.

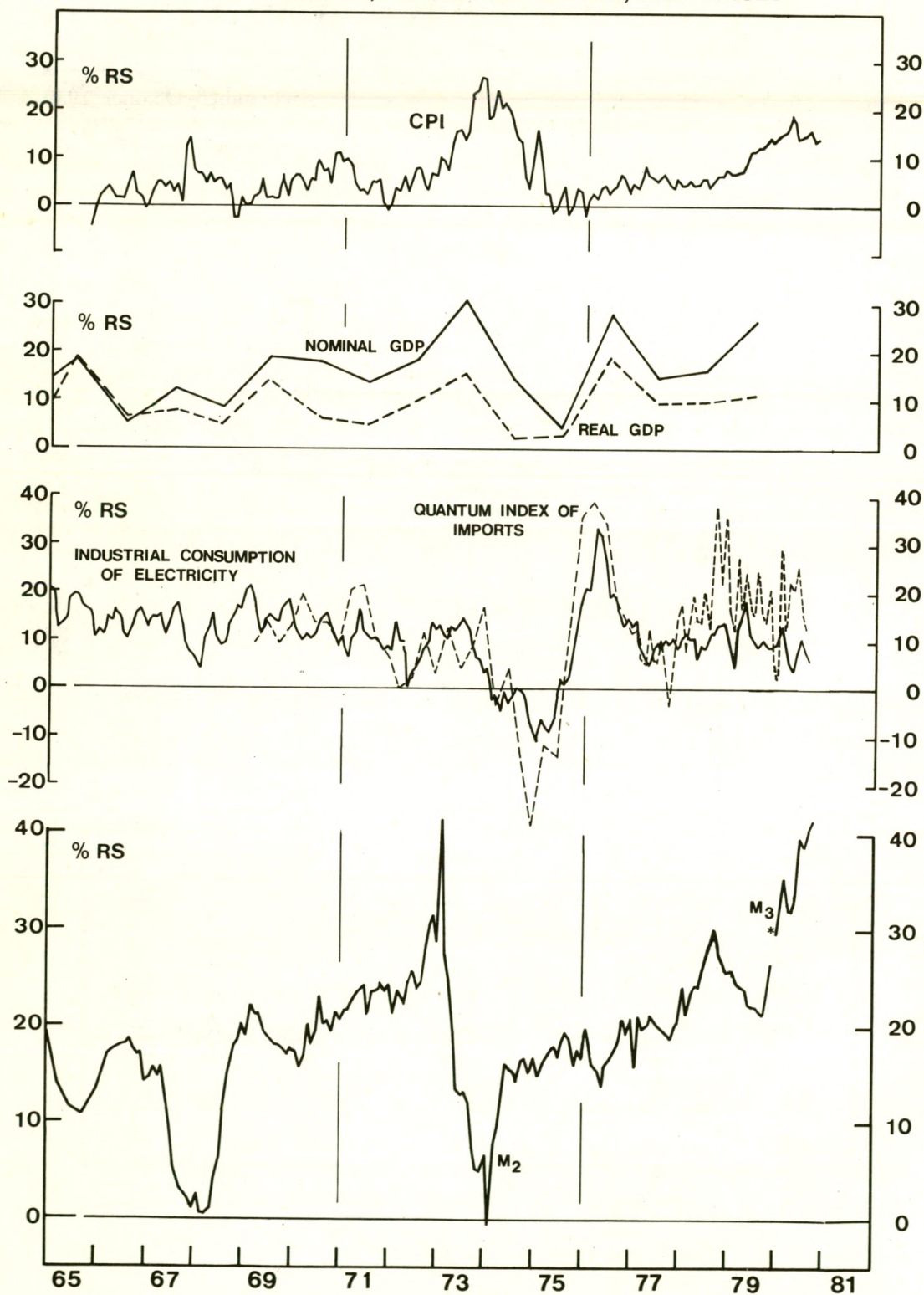
% RS - Percentage Rate of change over Same period of preceding year.

SA - Seasonally Adjusted.

SAAR - Seasonally Adjusted at Annualised Rate.

HONG KONG

CHART 1 : MONEY, OUTPUT INDICATORS, AND PRICES



* CHANGE OF M₂ TO M₃ SERIES

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HONG KONG

CORRECTING FOR INADEQUATE STATISTICS

The published statistics of money supply in Hong Kong contain not only Hong Kong dollar deposits at the Licensed Banks and at Deposit Taking Companies, but also deposits in foreign currencies at these two groups of institutions. Therefore the reported statistics overstate the HK\$ money supply by the amount of non-HK\$ or foreign currency deposits. At the present time it is not possible to separate these two types of deposits. However, on the asset side of the banks' accounts the loans of both Licensed Banks and DTCs are divided into "Loans and Advances in Hong Kong" and "Loans and Advances Abroad". If it is assumed that all loans and advances outside Hong Kong are in foreign currencies, and it is further assumed that these foreign currency loans are funded from non-bank non-Hong Kong dollar sources, then one may use the amount of these loans and advances abroad as an estimate of the amount of foreign currency deposits in the reported money supply. Deducting these amounts from the total reported money supply M_3 provides an estimate, based on the two assumptions above, of the money supply in Hong Kong dollars. The results of this estimate (Method A) are as follows:

	<u>M₃</u>	<u>M₃ minus loans by Banks & DTCs Abroad</u>	<u>Year-to-year % changes</u>	
1979 Jan.	79441	41027	-	-
Feb.	79701	40641	-	-
Mar.	80959	42059	-	-
Apr.	82033	42284	-	-
May	83628	42893	-	-
Jun.	85356	43914	-	-
Jul.	86772	44049	-	-
Aug.	88464	45660	-	-
Sep.	90840	48103	-	-
Oct.	93598	50946	-	-
Nov.	95833	51264	-	-
Dec.	99765	54209	29.7	37.8
1980 Jan.	105032	61137	32.2	49.0
Feb.	107770	62529	35.2	53.9
Mar.	106657	59978	31.9	42.6
Apr.	107967	62252	31.8	47.2
May	111882	64776	33.8	51.0
Jun.	119120	69980	39.6	59.4
Jul.	120481	68995	38.8	56.6
Aug.	124207	72203	40.4	58.1
Sep.	128457	74260	41.4	54.4

The estimated HK\$ money supply series and the reported mixed currency series show the same general pattern of acceleration in 1980 except that the HK\$ series has been growing much more rapidly. The reason for the difference is that loans and advances abroad (which we have assumed to be all denominated in foreign currency and funded with foreign currency) have not been growing so rapidly while deposit and loan growth in Hong Kong have been booming.

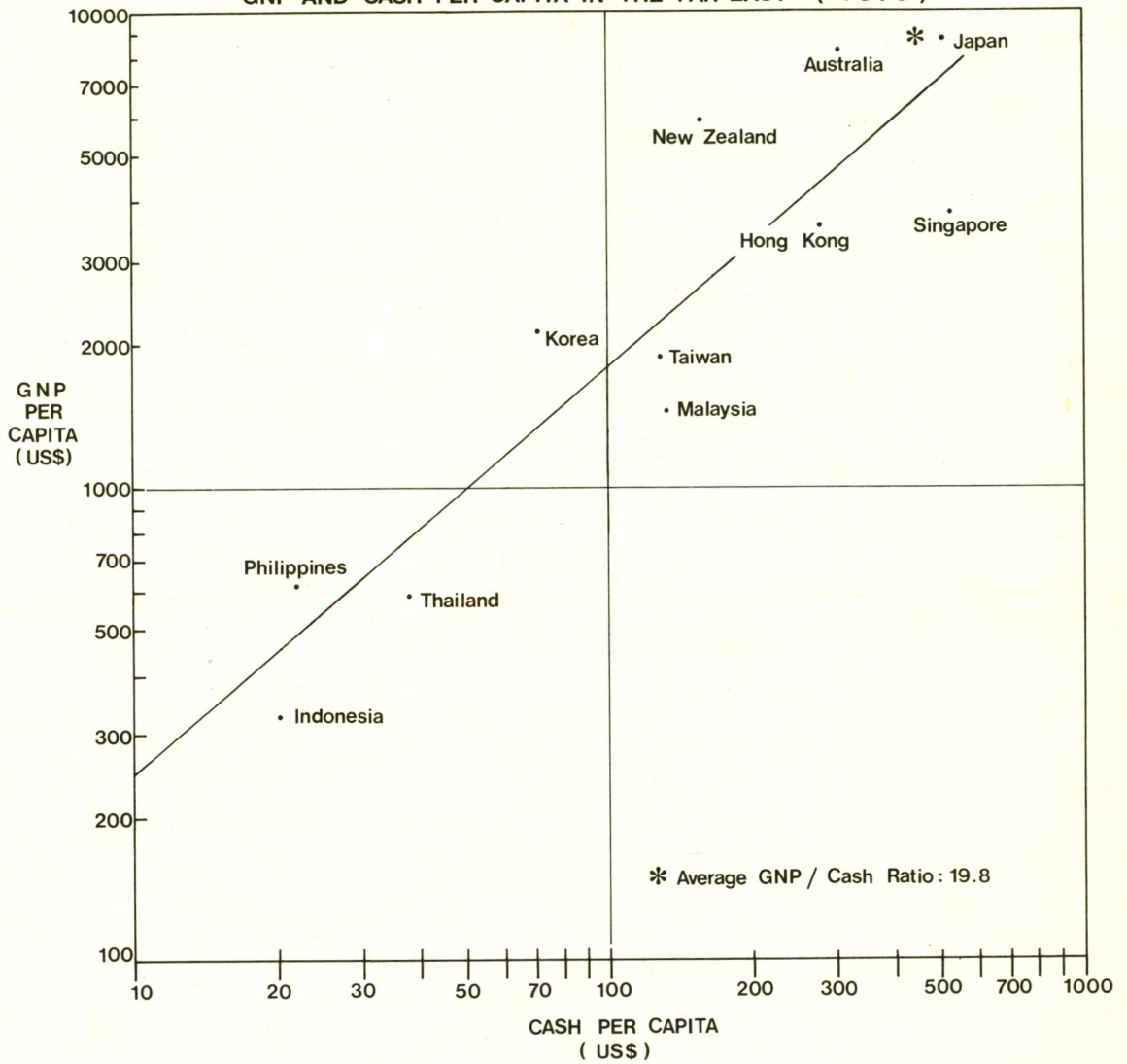
The problem with the Method A estimate is that it assumes that all non-Hong Kong currency denominated loans have been funded from non-bank sources outside Hong Kong whereas much of the lending in non-Hong Kong currency is in fact funded from banks abroad. Therefore a better estimate might be obtained if one adjusted the series above for the net lending by banks overseas to banks and DTCs in Hong Kong. As an example, the computation for the month of July 1980 is set out below:

		July 1980 HK\$ millions equivalent
	Deposits of banks and DTCs with banks abroad	101,202
plus	Loans to non-banks abroad	<u>51,486</u>
equals	Estimated foreign currency assets	152,688
minus	Foreign currency liabilities	
	(Borrowings by Banks and DTCs from Banks abroad)	<u>132,403</u>
equals	Estimated non-bank foreign currency deposits	<u>20,285</u>

This estimate of non-bank foreign currency deposits may now be deducted from the published M_3 series to give an estimate of the pure Hong Kong dollar money supply. Again, it has to be assumed for these purposes that, taking the system as a whole, the banks and DTCs are maintaining a matched overall foreign exchange position - i.e. that foreign currency loans are generally funded by foreign currencies. The results of this second method of estimation (Method B) are as follows:

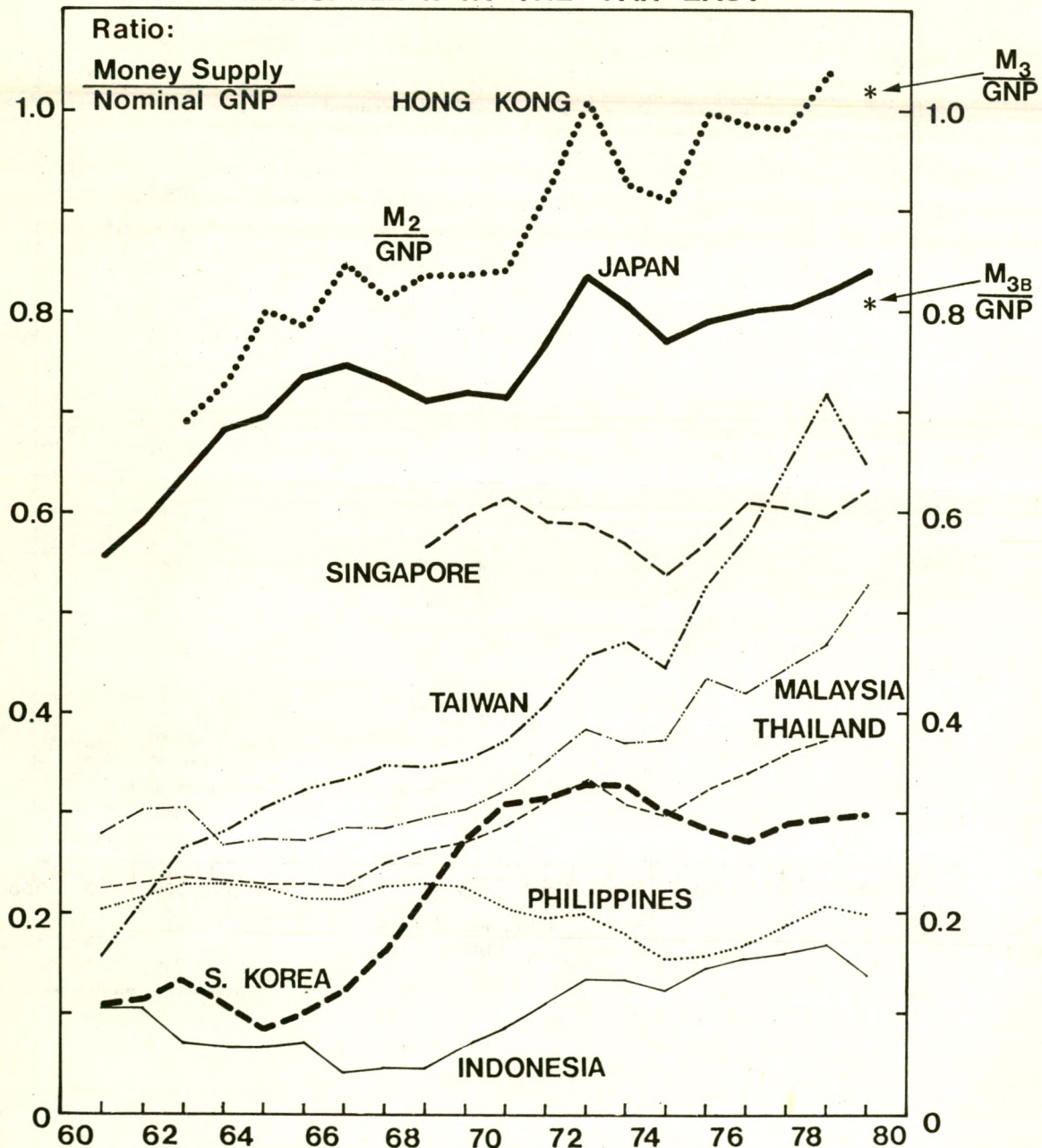
		M_3	M_3 minus estimated non-bank foreign currency deposits	Year-to-year % changes	
1979	Jan.	79441	64094	-	-
	Feb.	79701	66421	-	-
	Mar.	80959	66025	-	-
	Apr.	82033	67006	-	-
	May	83628	66200	-	-
	Jun.	85356	67722	-	-
	Jul.	86772	69238	-	-
	Aug.	88464	70579	-	-
	Sep.	90840	72253	-	-
	Oct.	93598	73876	-	-
	Nov.	95833	75514	-	-
	Dec.	99765	79060	29.7	37.8

CHART 2
GNP AND CASH PER CAPITA IN THE FAR EAST (1979)



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CHART 3 MARSHALL K IN THE FAR EAST



M_{3B} is Hong Kong's money supply as estimated by Method B.

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	<u>M3</u>	<u>M₃ minus estimated non-bank foreign currency deposits</u>	<u>Year-to-year % changes</u>	
1980 Jan.	105032	83965	32.2	31.0
Feb.	107770	86660	35.2	30.5
Mar.	106657	86318	31.9	30.7
Apr.	107967	88933	31.8	32.7
May	111882	92237	33.8	39.3
Jun.	119120	98817	39.6	45.9
Jul.	120481	100196	38.8	44.7
Aug.	124207	104517	40.4	48.1
Sep.	128457	110498	41.4	52.9

Two pieces of evidence suggest that our estimated HK\$ money supply might provide a reasonable approximation for the actual HK\$-denominated money supply. The first is that the separately published statistics for External Liabilities and Claims of Licensed Banks and DTCs, which do provide a breakdown between HK\$ currency and foreign currencies, show that the overwhelming proportion of these external transactions outside Hong Kong are denominated in foreign currencies.

	<u>Liabilities to Banks outside HK</u>		<u>Loans to (=claims on) Banks outside HK</u>		<u>Loans to (=claims on) non bank customers outside HK</u>	
	<u>HK\$</u>	<u>Non HK\$</u>	<u>HK\$</u>	<u>Non HK\$</u>	<u>HK\$</u>	<u>Non HK\$</u>
June 30, 1980 (HK\$ million)						
Banks	2,464	84,529	6,973	68,943	480	22,063
DTCs	250	38,706	235	21,052	619	24,309
Combined %	2.2	97.8	7.4	92.6	2.3	97.7

The second suggestive piece of evidence depends on the typical relation between the quantity of domestic currency or money in an economy and the GNP of that economy. If one considers the simple relation between currency per capita and GNP per capita, it is apparent from Chart 2 that Hong Kong is not at all unusual. The average amount of currency held per unit of income in 1979 was not out of line with the currency per unit of income for other Asian Pacific Rim economies at similar stages of development. However, if the comparison is widened to include deposit money, and Hong Kong's published M₃ statistics are used for this purpose, then it is clear that Hong Kong's Money-to-GNP ratio is significantly out of line with other economies of Asia. (See Chart 3.) This may be explained in part by the possibility that being the Asian region's main financial centre and having no exchange controls Hong Kong has attracted funds from the region's less secure and less stable areas. Insofar as these funds are held in the form of cash balances at Hong Kong banks they might account for a higher Money-to-GNP ratio in Hong Kong than elsewhere, but it seems unlikely that the full extent of the discrepancy between

Hong Kong and other countries is fully accounted for by the existence of such non-resident deposits. Adjusting the M_3 money supply statistics by method B would reduce the Money-to-GNP ratio for Hong Kong to a more 'normal' level and in so doing provides some support for our estimates of the money supply in Hong Kong dollars.

Due to the shortcomings of the existing financial statistics moves are afoot to require the Licensed Banks and other deposit-taking institutions to submit returns to the Secretary of Monetary Affairs in a different format to that currently collected by the Banking Commissioner's office. While the Banking Commissioner's returns may be valid enough for purposes of prudential supervision*, the statistics they yield are not appropriate for monetary analysis. In particular the standard Monetary Survey tabulation adopted by the IMF cannot be constructed from the published statistics. The editors of AMM have long maintained that the statistics did not enable one to differentiate between Hong Kong dollar denominated assets or liabilities and foreign currency denominated assets or liabilities.

As Hong Kong has increasingly become an international financial centre, there is a danger that this deficiency in the statistics has become more important. Because Licensed Banks in Hong Kong have engaged in large-scale international loans in US dollars (or in other major currencies), their assets and liabilities as reported by the Banking Commissioner's statistics have been swollen by this intermediary function. The provision of these credits in foreign currencies by Hong Kong banks acting as agents for overseas affiliates or on their own account has no bearing on inflation in Hong Kong. Nevertheless Hong Kong's money supply statistics are overstated, and to that extent, analysts, commentators and the authorities themselves are likely to be misled as to the actual rate of monetary growth in Hong Kong.

The basic chain of relationships one is interested in studying as a monetary analyst is the following:

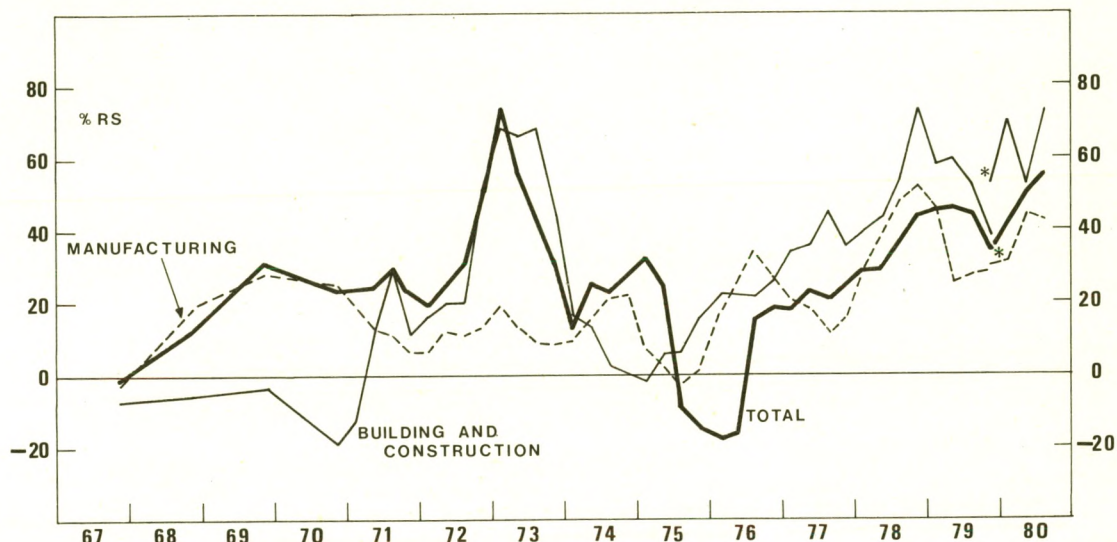
$$\left(\begin{array}{l} \text{Money Supply} \\ \text{in local currency} \end{array} \right) \times (\text{Velocity}) = (\text{Nominal GNP}) \begin{array}{l} \swarrow \left(\begin{array}{l} \text{Real GNP} \end{array} \right) \\ \searrow \left(\begin{array}{l} \text{Inflation in local} \\ \text{currency terms} \end{array} \right) \end{array}$$

The inclusion of non-Hong Kong dollars in the statistics purporting to be the Hong Kong money supply diminishes the possibility of establishing a satisfactory chain of statistical relationships between money and inflation in Hong Kong. The inclusion of non-Hong Kong currency in the Hong Kong money supply statistics is as though the Bank of England were

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* Subject to the reservations set out on p.12 of AMM Vol. 3 No. 2.

HONG KONG

CHART 4 : LOANS AND ADVANCES

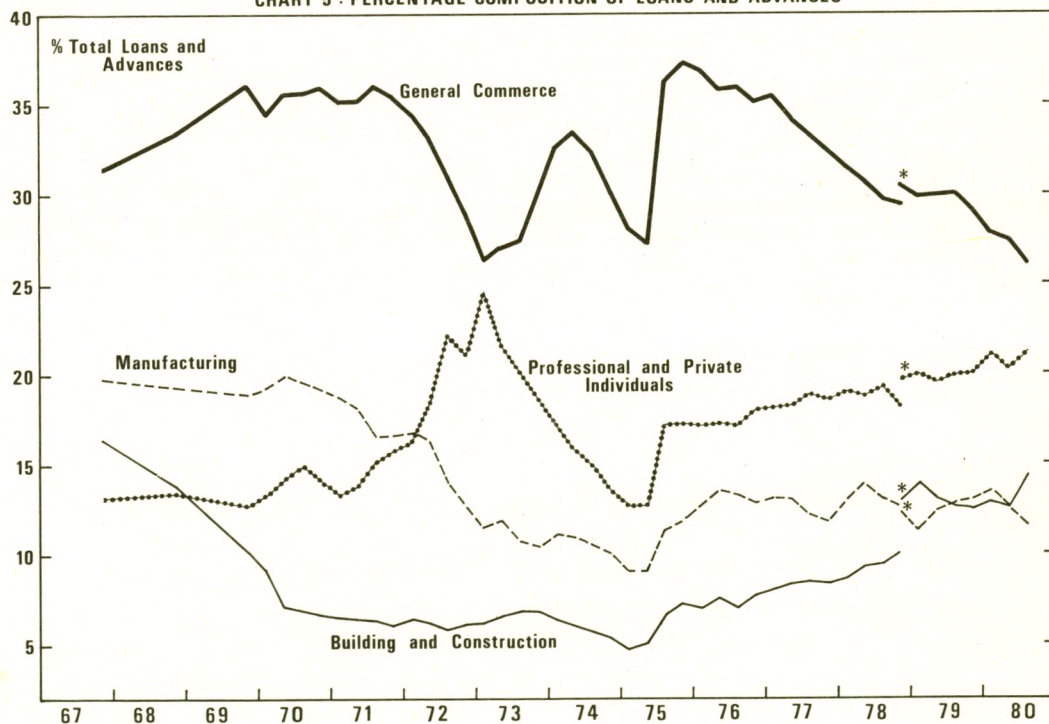


* Includes loans and advances by DTC's.

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HONG KONG

CHART 5 : PERCENTAGE COMPOSITION OF LOANS AND ADVANCES



* Includes loans and advances by DTC's.

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Extract from Legal Supplement No. 3 to the
Hong Kong Government Gazette
Friday, 13 June, 1980

MONETARY STATISTICS BILL

C203

A BILL

To

Provide for the collection of statistical information from banks and deposit-taking companies.

Enacted by the Governor of Hong Kong, with the advice and consent of the Legislative Council thereof.

1. This Ordinance may be cited as the Monetary Statistics Ordinance 1980, and shall come into operation on a day to be appointed by the Governor by notice in the *Gazette*. Short title and commencement.

2. In this Ordinance, unless the context otherwise requires— Interpretation.
“bank” means a bank licensed under the Banking Ordinance; (Cap. 155.)
“deposit-taking company” means a company registered as a deposit-taking company under the Deposit-taking Companies Ordinance; (Cap. 328.)
“Secretary” means the Secretary for Monetary Affairs.

3. (1) Every bank and every deposit-taking company shall, within 14 days after the last day of each calendar month, submit to the Secretary in a form specified by him a return setting out such statistical information relating to the assets and liabilities of its offices and branches as he may require for the purpose of measuring developments in the monetary sector. Returns.

(2) In addition to any return required by subsection (1) the Secretary may, by notice in writing, call upon any bank or deposit-taking company to submit to him, within a time and in a form specified in the notice, such other return or such further or fuller return of statistical information as he may require for the purpose of measuring developments in the monetary sector.

(3) The Secretary may require any return or information submitted to him pursuant to a requirement under this section to be accompanied by a certificate of the auditors of the bank or deposit-taking company as to whether or not, in the opinion of the auditors, the return or information is correctly compiled from the books and records of the bank or deposit-taking company.

4. (1) The Secretary and every person who is or has been authorized by him to have access to returns and information submitted by banks and deposit-taking companies under this Ordinance shall preserve and aid in preserving secrecy with regard to all such returns and information. Secrecy.

(2) Neither the Secretary nor any other person shall disclose to any unauthorized person any return or information submitted by any bank or deposit-taking company under this Ordinance.

(3) Neither the Secretary nor any other person shall suffer or permit any unauthorized person to have access to any return or information submitted by any bank or deposit-taking company under this Ordinance.

(4) Except in respect of a prosecution under this Ordinance, no return or information submitted by any bank or deposit-taking company under this Ordinance shall be disclosed or used in any proceedings, and neither the Financial Secretary nor the Secretary nor any person who has been authorized to have access to any such return or information shall be compellable in any proceedings to produce or give evidence regarding any such return or information.

(5) Nothing in subsection (2) shall apply to the disclosure of information—

- (a) by the Secretary to the Financial Secretary;
- (b) in the form of a summary of similar information provided by a number of banks or deposit-taking companies if the summary is so framed as to prevent particulars relating to the business of any particular bank or deposit-taking company being ascertained from it; or
- (c) to any court or magistrate for the purpose of proceedings instituted for an offence under this Ordinance.

Offences.

5. (1) Any person who contravenes section 4 commits an offence and is liable on conviction to a fine of \$50,000 and to imprisonment for 2 years.

(2) Any person who—

- (a) refuses or fails to submit any return or information which he is required to submit under this Ordinance; or
- (b) wilfully or negligently makes any false return, or gives any false information, or misleads or attempts to mislead the Secretary,

commits an offence and is liable on conviction to a fine of \$50,000 and in the case of a continuing offence, to a further fine of \$2,000 for every day during which the offence continues.

Explanatory Memorandum

The purpose of this Bill is to require licensed banks and registered deposit-taking companies to supply information to the Secretary for the Monetary Affairs so that he can more accurately measure developments in the monetary sector.

At present banks and deposit-taking companies make returns to the Commissioner of Banking and the Commissioner of Deposit-taking Companies respectively, for the purposes of prudential supervision. These returns however are not designed to provide adequate information for a full understanding of developments in the monetary sector, and such information as they do contain may not be passed on to anyone outside the Commissioner's office.

Clause 1 provides for the commencement of the Bill.

Clause 3 empowers the Secretary for Monetary Affairs to require banks and deposit-taking companies to provide him with statistical information relating to their assets and liabilities.

Clause 4 provides for the preservation of secrecy with regard to information provided to the Secretary.

Clause 5 makes contravention or failure to comply with the provisions of the Bill an offence. Breaches of the secrecy provisions are punishable by a fine of \$50,000 and imprisonment for 2 years.

The administration of this Ordinance will require additional government staff at an estimated annual cost of approximately \$312,000.00.

to include London-based Eurodollar or other Eurocurrency deposits in its computation of the British money supply figures. Like other central banks and monetary authorities the Bank of England has acknowledged the importance of controlling the sterling-denominated money supply as a means to achieving lower rates of inflation, but so far has achieved no great success in controlling the supply of money. This is partly for the structural reasons explained in AMM Vol. 3 No. 6, and partly because of its preference for trying to act on the demand for loans through interest rates rather than directly on the supply of money by controlling the supply of base money to the banking system. The Hong Kong banking system suffers from a similar structural problem, but rather than confront it directly the local authorities have preferred to act indirectly, cajoling the banks to manipulate lending rates and thereby encourage or dampen the demand for loans.

Since some of the deficiencies in Hong Kong's banking structure have become apparent the authorities have acted with considerable circumspection. Despite the booming stock markets and property markets their actions have been limited to moral suasion, and they have resisted any specific reforms. Their main substantive innovation has been the introduction of a Monetary Statistics Bill (see box on pp. 10 & 11) which will enable the Secretary for Monetary Affairs to collect data separately from the Banking Commissioner.* The statistical returns currently being designed for use under the new Ordinance will require the banks and DTCs to differentiate between local currency deposits and foreign currency deposits. It will then be feasible to construct a proper money supply series. It would be beneficial if when designing the new reporting system the authorities would have regard to internationally recognised conventions and, besides publishing the fully consolidated balance sheets of banks and DTCs (preferably including interbank funds), arrange to publish the data in the format of IMF's comprehensive Monetary Survey tables. Among other things this would show the money supply in its various definitions, and non-monetary liabilities (including Hong Kong dollar CDs - currently excluded from the money supply) on one side of the table, and on the other side of the table the credit counterparts (banking lending to the public sector and the private sector) equivalent to domestic credit, and the net foreign assets of the banking system as the balancing item.

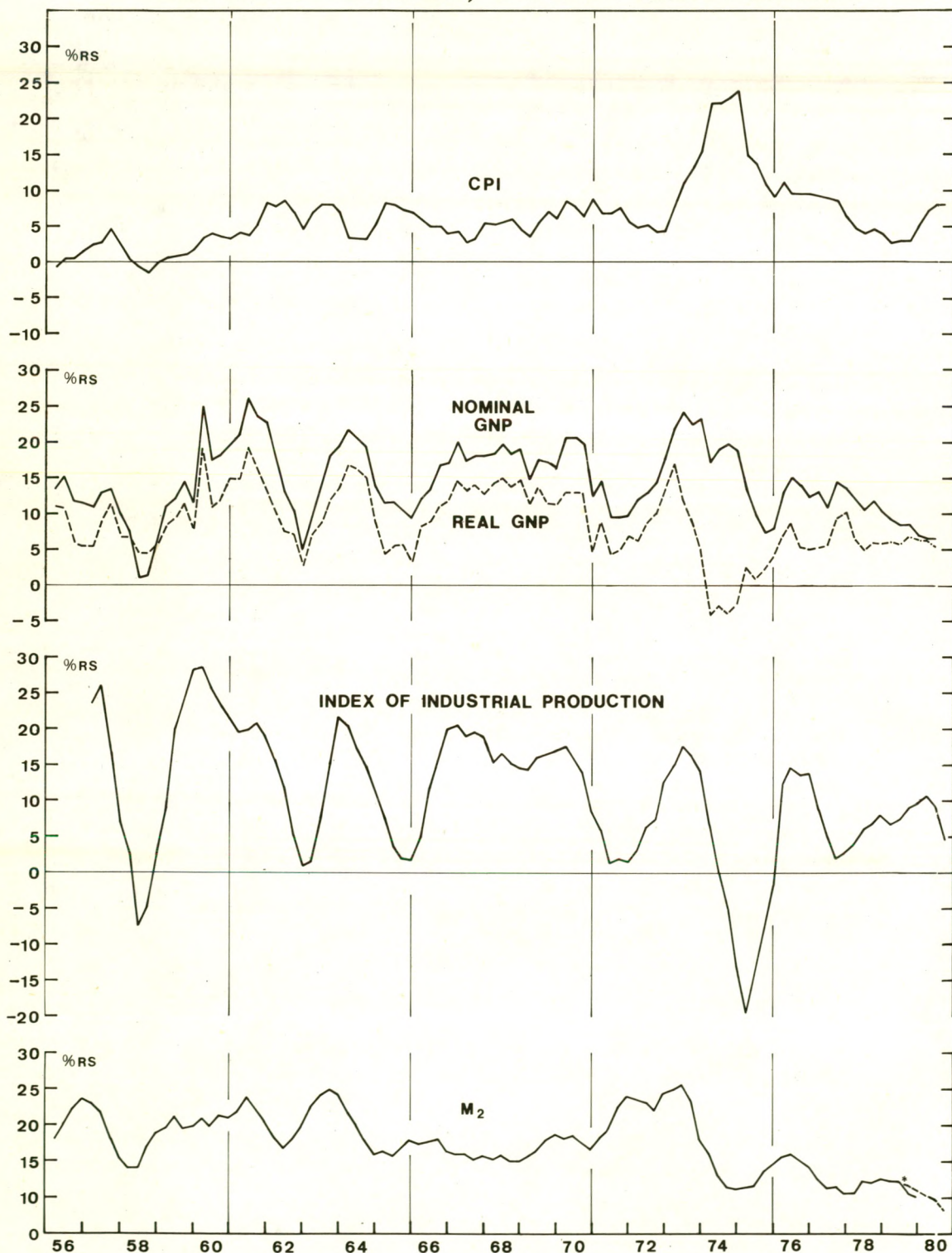
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* Another proposal that has been aired is to make the Exchange Banks Association into a statutory body, and to require all licensed banks to be members. Such a step would appear to convert a private non-comprehensive cartel into a government-sponsored industry-wide cartel, presumably with a bureaucrat attending the EBA's meetings. From an analytical point of view it is hard to see what benefits such a measure would have since it does not deal with the underlying structural problems of controlling credit or money creation. It does nothing to limit the access of banks to reserve assets, and it appears to rely on a market-sharing arrangement (possibly coercive) among the participants in preference to the impersonal operation of market forces.

In general any move away from statistical reporting based on prudential supervision requirements towards a more analytically based approach is to be welcomed. It is a short step from correct analysis to making well-informed improvements to the present system. In the recent past the statistical drift has been towards increased emphasis on the maturity spectrum of bank assets and liabilities - a quagmire which preoccupied the Bank of England for many years, and which was essentially derived from ideas about the desirable degree of liquidity of individual institutions' balance sheets. A move in the other direction back towards concern about the aggregate amount of liquidity (in the sense of the growth rate of the quantity of money) and its relation to the inflationary trend of the equity and property markets or the economy as a whole would promote the long-run healthy development of Hong Kong's financial markets and would contribute to pinpointing the true sources of the local inflation.

JAPAN

CHART 1 : MONEY, OUTPUT AND PRICES



*Change in data series to M₂ + CD's

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JAPAN

HOW TO COPE WITH AN OIL CRISIS - A TEXTBOOK CASE

During the past year Japan has adjusted with remarkable speed and success to the second oil crisis within a decade. After the first oil crisis of 1973 the economy went into a tailspin: industrial output plummeted by 23% from peak to trough, and real GNP declined for four successive quarters (on a year-to-year basis). Inflation soared into double digits from mid-1973 bringing a long period of stagflation in its train.

This time the disruption of the second oil crisis has been weathered with far less damage despite the fact that the financial burden has been very similar. Oil prices were raised sharply in the spring of 1979, but it has taken over a year for the economy to slow down, and though the pace of manufacturing production has slowed quite considerably, the extent of the slowdown as measured by the broader GNP statistics has been much more modest. Indeed it is now certain that Japan will avoid a recession (defined as an absolute decline in GNP). In addition, the symptoms of stagflation are almost entirely absent this time: not only are some of the indices of inflation now falling rapidly, but the underlying domestic inflationary pressure in Japan appears to be negligible. Compared with the previous cycle, Japan has escaped the second oil crisis without any long term dislocations.

What has been the secret of Japan's successful adaptation? This question can be answered most succinctly from a macro-economic standpoint as follows:

- (1) The transformation of Japanese monetary policy since the first oil crisis explains in large measure
 - (a) the relative stability of total nominal GNP and
 - (b) the low absolute level of inflation throughout the last 18 months.
- (2) Instead of being suppressed to shield the economy from change, the price mechanism has in certain important respects been encouraged to operate in such a way as to accelerate those changes. As a result major shifts have occurred in the composition of GNP which have enabled Japan to adapt exceptionally rapidly to the second oil crisis.

In effect the secret of success is not to be found in any differences of external circumstances, but in the deliberate and carefully designed domestic policies adopted by the Japanese authorities long before the second oil crisis broke out. These policies placed primary emphasis on internal price stability through control of the money supply on the one hand, but on the other hand permitted maximum adaptation to external price changes through a flexible exchange rate, a more flexible interest rate structure, and virtually complete official

abstention from any form of wage or price controls. One might say that stability of the absolute or overall price level was the ultimate target but individual or relative prices were left free to move up and down until a new general equilibrium was established. The ends (overall price stability) were not confused with the means (flexibility of individual prices) - a rare accomplishment even in the less interventionist economies of the Asian Pacific Rim.

(1) The transformation of Japanese monetary policy

The cornerstone of Japanese monetary policy in the period prior to the first oil crisis was a fixed exchange rate vis-a-vis the US dollar. This policy had been adopted in 1949 when Japan joined the nations who adhered to the Bretton Woods system of fixed parities by establishing a single exchange rate of ¥360 per US dollar. The implicit consequence of this system was that monetary growth became a slave to the balance of payments. If the balance of payments was in surplus the central bank would be buying up surplus foreign exchange in the market, supplying domestic currency in the form of bank reserves, and thereby fuelling monetary expansion. Conversely, if the balance of payments was in deficit the tendency would be toward monetary contraction. Of course central bankers could and did try to escape from this straightjacket because almost invariably they lacked the determination to allow the process to work itself out naturally. Often they believed that they could do better by speeding up the expansionary process or slowing down the contractionary mechanism.

In Japan this attempt to escape the harsh disciplines of the dollar standard (or the gold-dollar-exchange standard) was encapsulated in a long-running debate over the objectives of domestic economic policy. Simply stated the argument concerned the optimum way to attain three objectives simultaneously: (1) full employment (or a high rate of economic growth), (2) equilibrium in the balance of payments, and (3) price stability. Much discussion and ingenuity was devoted to these problems. One of the most celebrated contributors to the academic debate was the Dutch economist Jan Tinbergen who demonstrated that the attainment of each single "objective" required at least one policy "instrument". In the practical world where the debate was less abstract and the realities of defending the ¥360 exchange rate on a day-to-day basis were tiresomely demanding, it gradually became apparent that the simultaneous achievement of these three objectives was virtually impossible except perhaps for a very brief, fleeting moment during each business cycle.

Another well-known contributor to the academic debate was an economist called A.W. Phillips who established a reasonably close empirical relation between the level of unemployment (or employment), and the rate of inflation. He showed that there appeared to be a direct trade-off between these two objectives i.e. the higher the rate of unemployment, the lower the rate of inflation, and conversely the lower the rate of unemployment, the higher the rate of inflation. Unfortunately for this

proposition, the facts are that as inflation gradually accelerated through each economic cycle in the 1960s and 1970s, in country after country the unemployment problem became worse, not better, culminating in stagflation - high unemployment plus high inflation - in the aftermath of the 1973-74 oil crisis. This vivid illustration of the shortcomings of Phillips' observations in practice, together with further work in economic theory, have gradually undermined the validity of the "Phillips curve".

One element in the transformation of Japanese monetary policy since 1974 therefore consists of the outright rejection of the idea that there is any meaningful trade-off between these different objectives. In the world of rational expectations - that is, in a world where individuals and firms correctly understand the consequences of policy actions - it is futile to stimulate higher levels of activity and employment by accelerating money growth because people simply react by raising prices or demanding higher wages immediately, with the net result that no new jobs are created and prices are merely raised to match the increase in money supply. Since the Japanese authorities today believe that there is no meaningful trade-off between price stability and employment, they would regard any monetary acceleration designed to counter a slowdown of economic activity (resulting from the oil price hikes for example) as ill-advised and even counterproductive.

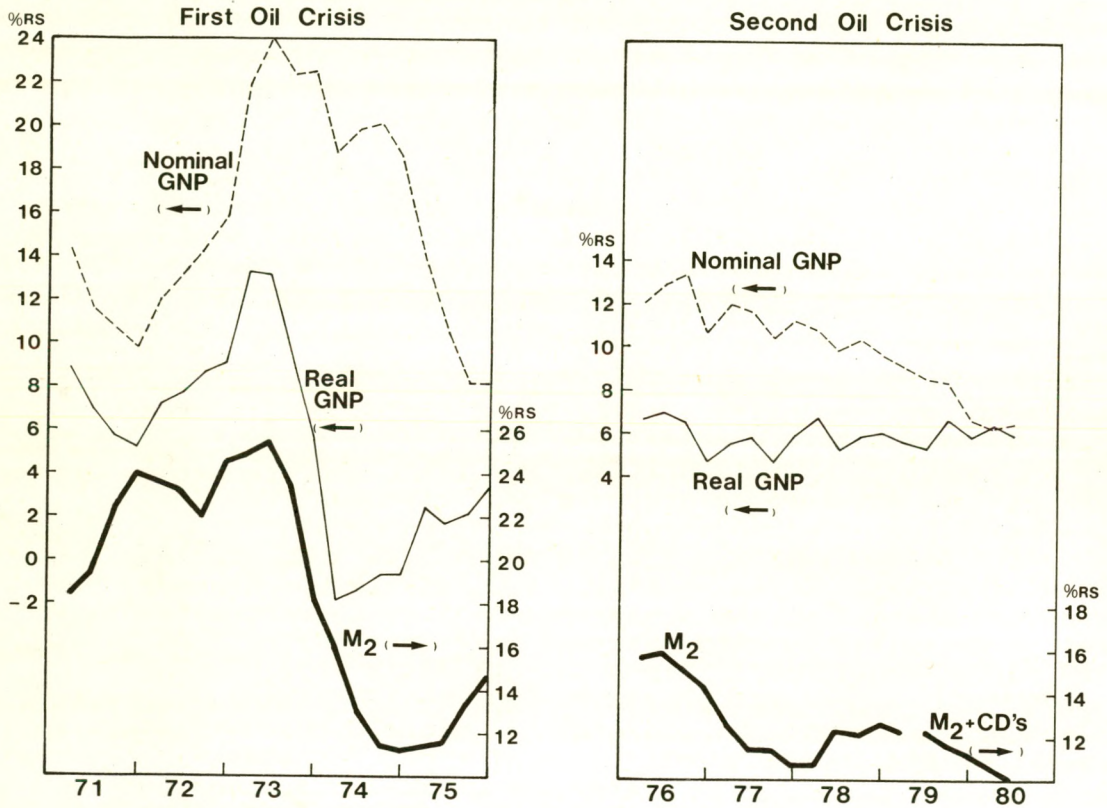
The Bank of Japan now believes that without stable monetary growth, price stability is impossible. However, for monetary stability, two necessary conditions are: (a) exchange rate flexibility and (b) interest rate flexibility. So far as the three traditionally cited objectives of policy are concerned, theoretical argument and actual experience show that (1) economic growth will recover and unemployment will fall as inflation declines and real purchasing power builds up; (2) the balance of payments equilibrium is automatically achieved without central bank intervention in a freely determined foreign exchange market; and (3) overall price stability follows from the choice of an appropriate monetary growth rate. In other words all three objectives are simultaneously attainable provided the appropriate monetary framework is maintained by the authorities and the exchange rate is left to the free market. Without these conditions the objectives can only be attained temporarily.

However, since Japan has actually pursued this new monetary policy for over 6 years, we can now examine the evidence to see whether in fact (and to what extent) the levels of activity or employment have held up through the second oil crisis, and similarly whether in fact overall price stability can be maintained in the face of an externally-imposed increase in oil prices.

The contrast between monetary policy before and after the first oil crisis is illustrated in Charts 2 and 3 (P.T.O.). It can readily be seen that the first oil shock was preceded by a prolonged period of monetary expansion, with rates of growth of

JAPAN MONEY AND GNP GROWTH

CHART 2

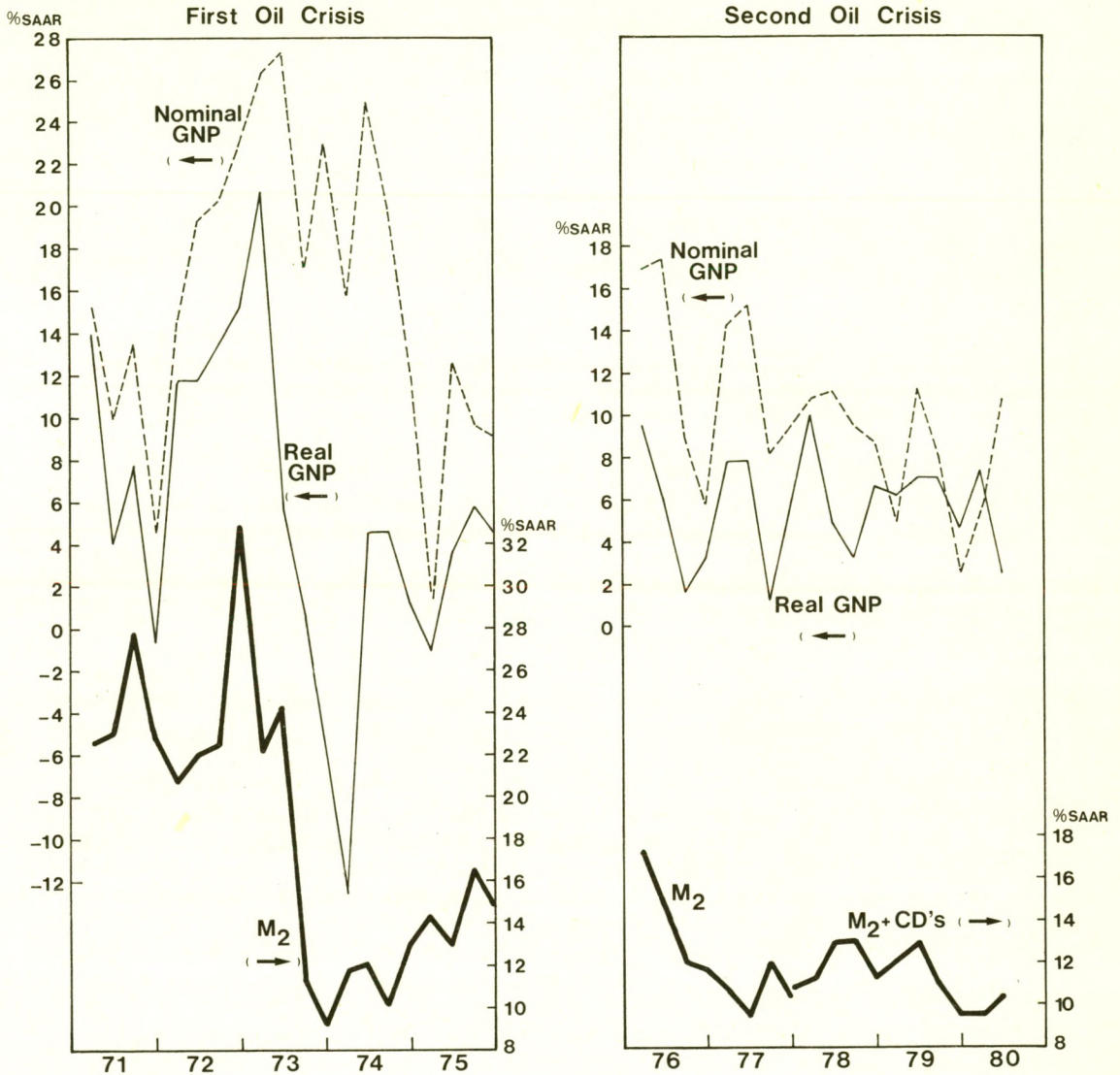


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STATISTICAL FOOTNOTE

The two panels of Chart 2 above show year-to-year changes in quarterly data for the broad definitions of money preferred by the Bank of Japan, together with year-to-year changes in nominal and real GNP. Japanese monetary data is published in two forms: month-end data and month-average data. The actual figures for month-end data are computed and released with a 5-6 week lag. However, for month-average data, not all institutions surveyed submit sufficient balance sheet data to enable the Bank of Japan to calculate the exact month-average figures without a considerable delay. The drawback

CHART 3



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with month-end data is that they are inevitably more volatile than month-average data. The drawback with month-average data is that they contain some estimates. Although the month-average statistics are only published in rate-of-change form it is nevertheless considered that these month-average rate-of-change data give the best guide to monetary conditions in Japan, and these are the statistics shown in our charts. The two panels of Chart 3 above show the same quarterly monetary and GNP series as in Chart 2, but in seasonally adjusted form at annualised rates.

M₂ averaging 22.8% p.a. between the end of 1970 and mid-1973. Immediately following the crisis monetary growth was severely restricted so that year-to-year growth rates fell to between 10 and 12% by the end of 1974. In the current cycle monetary policy was never particularly expansionary. The most expansionary period was in 1975-76 just after the first oil crisis, but subsequently the Bank of Japan has tightly controlled money growth within a narrow band, and as a consequence inflationary pressures have been much less than in the previous cycle. Growth of the nominal GNP has therefore been relatively stable compared with the sharp fluctuations experienced in the last episode.

The only prices to have risen steeply in this cycle are those of imported goods. The wide difference between various price movements is illustrated in Chart 5. Prices of imported goods rose by 83.5% year-to-year at their peak. The more broadly-based wholesale price index (which includes certain commodities and raw materials) rose by 24% at its peak. Consumer prices, an even broader index which includes a range of services, only rose by 9% at their peak. In other words, the broader the index, the lower the rate of inflation. But none of these indices is a comprehensive measure of overall inflation because each index only measures a particular basket of goods reflecting a certain category of expenditures. Looking at the overall deflator or price index for the GNP the inflation rate is even lower: in the 2nd quarter the year-to-year increase was a mere 1.1%.

The exceptionally low level of the overall GNP deflator implies that domestic costs in Japan are stable: there is no domestic source of inflationary pressure. The only prices to have reacted to the oil crisis are the prices of imported goods. In other words there has been a change in the relative price levels of imported and non-imported goods, but the average absolute level of overall prices as reflected in the GNP deflator has been quite static. Compared with many other countries this record is quite remarkable. (See Table 1 below.) It has important implications not only for the proper conduct of monetary policy in countries which have so far failed to control money growth successfully, but also for the future competitiveness of the Japanese economy and currency.

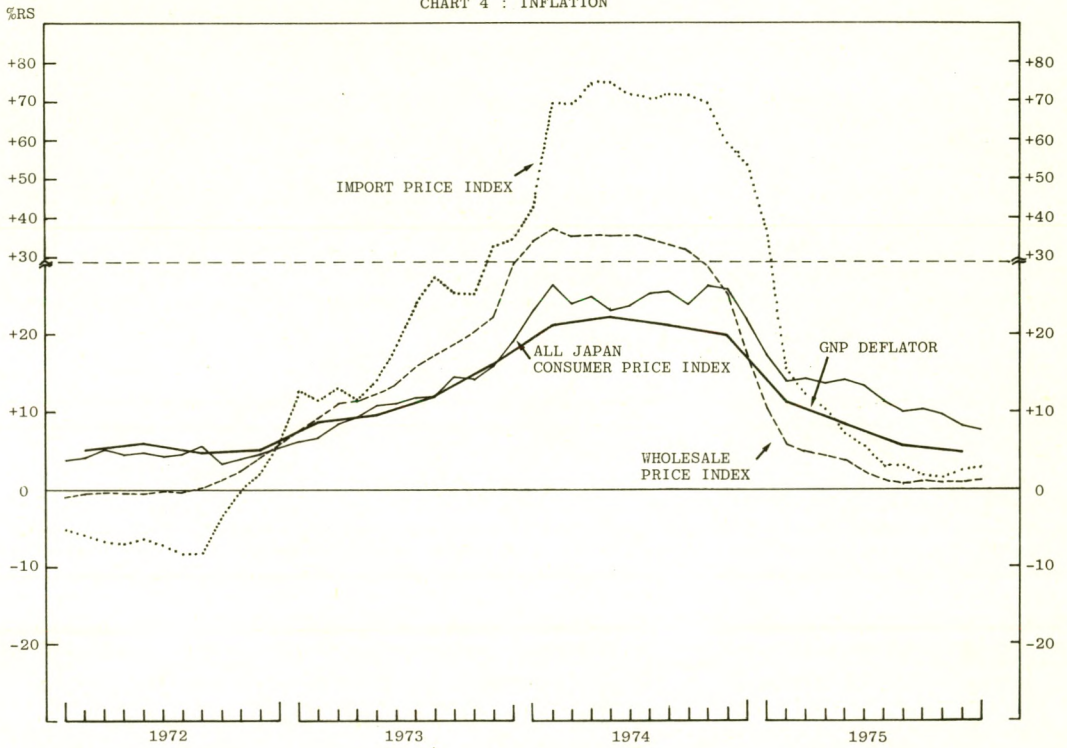
TABLE 1

Year-to-year increases in GNP deflators of major OECD countries

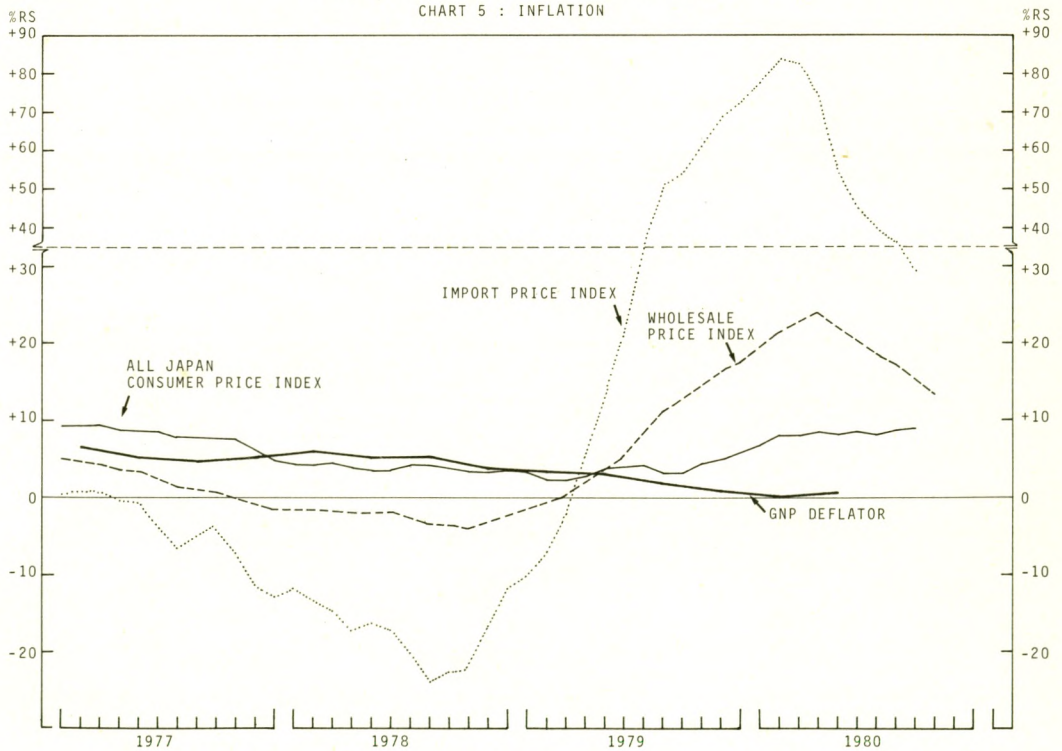
U.K.	19.0	U.S.A.	9.2
Australia	10.2	W. Germany	5.4
Canada	10.0	Switzerland	2.6
France	9.3	Japan	1.1

All data for 1980 second quarter, except France (1978) and Switzerland (1979).

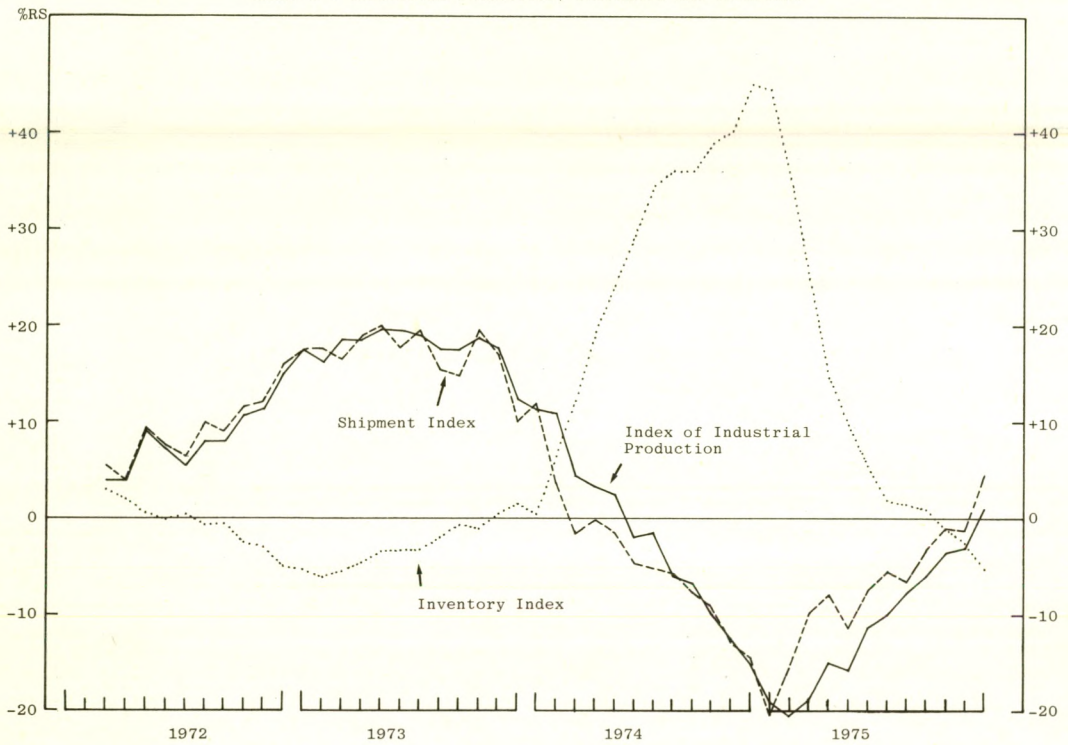
JAPAN'S RESPONSE TO THE FIRST OIL CRISIS
CHART 4 : INFLATION



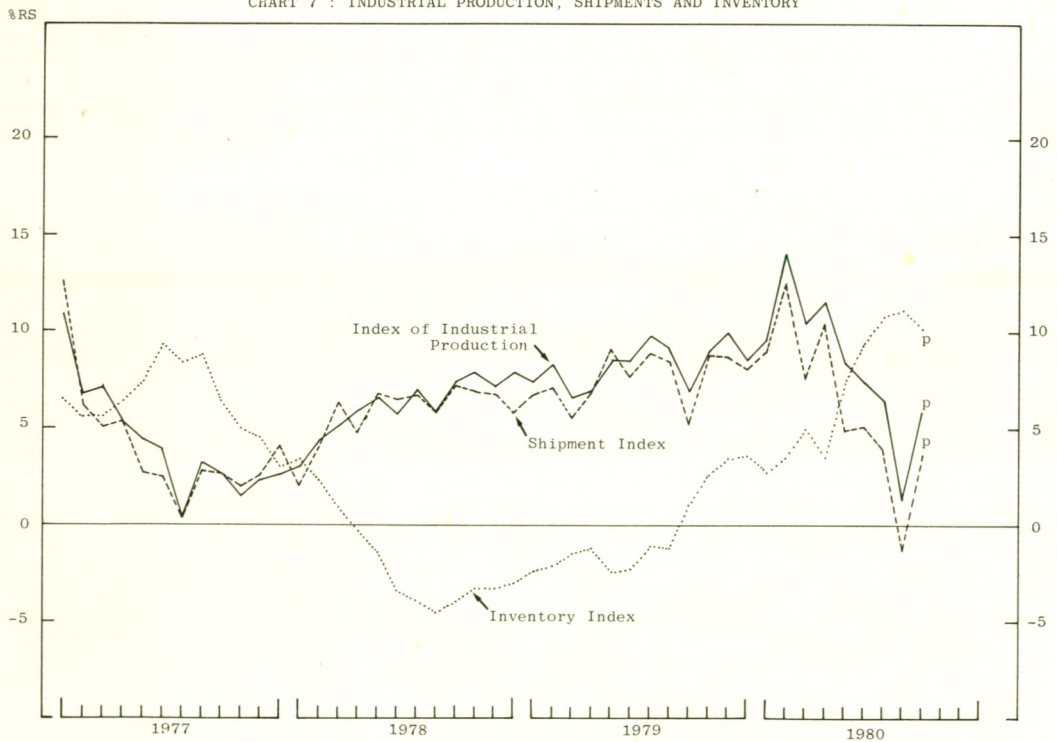
JAPAN'S RESPONSE TO THE SECOND OIL CRISIS
CHART 5 : INFLATION



JAPAN'S RESPONSE TO THE FIRST OIL CRISIS
 CHART 6 : INDUSTRIAL PRODUCTION, SHIPMENTS AND INVENTORY



JAPAN'S RESPONSE TO THE SECOND OIL CRISIS
 CHART 7 : INDUSTRIAL PRODUCTION, SHIPMENTS AND INVENTORY



(2) Changes in the Composition of Japan's GNP

When the first oil crisis struck Japan in late 1973 the real economy was booming. Following three successive quarters of double digit real economic growth in the final quarter of 1972 and the first two quarters of 1973, the economy continued to expand in the third and fourth quarters. (See Table 2 on p.24.) The strength of the economic upswing was shifting from private consumption expenditures to corporate equipment investment which expanded at a double-digit rate throughout 1973. The high level of domestic activity was reflected in the higher relative growth of imports shown in the right hand column of the table. (It should be noted that this trend had started well before the outbreak of the oil crisis and actually began to be alleviated very soon after it.)

As the GNP slumped in 1974 a series of changes began to occur in the composition of the total spending. Initially (in 1974) consumers cut back sharply, but as wages gradually caught up with inflation, real spending power began to recover in 1975 and 1976 so that activity in the consumer sector in these two years was actually quite bouyant. For companies, however, the environment was not nearly so happy. The table makes it quite clear that there was a progressive restriction of investment spending which continued through 1974 and 1975 and into 1976. Government expenditure was at first curtailed in late 1973 and through to the third quarter of 1974, but then a major programme of fiscal expansion began to take effect so that in 1975 the government's real spending was expanding at just over 10% compared with the preceding year. On the external side the end of the domestic boom brought a sudden end to the strong demand for imports. For the next three years export growth (in real terms) outpaced import growth as the Japanese economy struggled to pay its enormous fuel bills. This process was assisted by the depreciation of the yen from around ¥264 in 1973 to ¥308 in 1975-6.

In essence what was happening was that Japan was adapting instinctively to the changed world price structure. Consumers protected their position by bidding aggressively for higher wages and were largely successful in obtaining them. Companies protected their interests by cutting back drastically on output, on levels of inventory, and on investment spending. The government, as one might expect, took time to appreciate the situation and could only produce a stimulatory fiscal programme once it had corrected the excesses of 1972-73.

In the wake of the second oil crisis there have been some similarities, but there are also some striking differences. The figures suggest that instead of reacting instinctively, the reaction of the Japanese economy this time has been more measured and deliberate.

As can be seen both in Chart 2 and in the left hand column of Table 2 the growth of the real GNP has been very steady in the range 4.7-7.0% (year-to-year) since 1976. This overall stability, as we explained in the preceding section,

TABLE 2

Year-to-year Changes in Japanese Real GNP

		<u>Real GNP</u>	<u>Private Consumption</u>	<u>Corporate Equipment Investment</u>	<u>Government Spending</u>	<u>Export Growth minus Import Growth</u>
1972	Q1.	7.3	8.0	1.7	18.8	5.7
	Q2.	7.7	8.1	3.6	9.8	- 4.2
	Q3.	8.7	9.5	5.3	8.9	- 9.6
	Q4.	11.2	10.4	12.4	10.8	0.9
1973	Q1.	13.3	10.2	13.7	9.1	- 4.0
	Q2.	13.2	6.9	16.3	7.6	-17.0
	Q3.	9.3	7.1	21.1	1.9	-15.8
	Q4.	5.5	8.6	18.9	- 2.8	-24.1
1974	Q1.	- 1.9	0.7	- 1.3	- 6.1	-17.2
	Q2.	- 1.4	2.9	- 6.0	- 5.3	9.9
	Q3.	- 1.0	3.4	-14.0	- 1.1	13.7
	Q4.	- 0.7	- 0.9	-18.4	4.8	24.9
1975	Q1.	2.5	7.7	-17.5	10.7	23.9
	Q2.	1.8	5.7	-13.8	10.1	13.4
	Q3.	2.2	5.5	-10.2	10.2	8.6
	Q4.	3.4	6.0	-10.9	5.7	7.6
1976	Q1.	6.6	5.6	- 1.5	5.1	11.5
	Q2.	7.0	4.4	2.0	7.2	15.8
	Q3.	6.5	5.3	2.5	2.1	9.7
	Q4.	4.7	4.0	2.9	0.5	6.5
1977	Q1.	5.5	4.5	3.1	1.5	8.2
	Q2.	5.8	3.7	1.7	5.6	6.0
	Q3.	4.7	3.2	0.4	9.5	9.3
	Q4.	5.8	2.9	1.5	14.1	8.7
1978	Q1.	6.7	4.4	3.2	12.1	6.4
	Q2.	5.2	4.4	4.5	13.4	- 2.0
	Q3.	5.9	5.7	5.8	13.1	- 7.3
	Q4.	6.0	7.3	13.8	12.6	-23.1
1979	Q1.	5.7	7.2	19.4	10.6	-28.4
	Q2.	5.3	6.9	17.5	2.8	-19.2
	Q3.	6.7	6.0	18.9	2.4	- 9.9
	Q4.	5.9	3.9	10.7	0.7	8.9
1980	Q1.	6.5	3.2	6.5	- 2.8	24.1
	Q2.	5.9	1.4	6.6	- 4.3	22.9
	Q3.					29.0

is closely associated with the stability of monetary growth. In contrast, the behaviour of the components of the GNP has been quite variable. The consumer sector was gradually weakening through 1977 but began to pick up in mid-1978. There were then five quarters of rapid growth until the fourth quarter of 1979 when consumer spending dropped from 6.0% to 3.9%. Since that time the weakness in this sector has continued reflecting the fact that consumer prices were generally rising more rapidly than wages, thus eroding consumers' purchasing power. This time round wage-earners simply have not been able to raise their nominal wages sufficiently to compensate for higher import prices, and monetary expansion has in any case been too low to accommodate any wage-push, so much of the burden of adjustment has fallen on consumers.

In the corporate sector, investment was very strong in late 1978 and 1979, just as it was in 1973, and although its rate of expansion has slowed, there is little sign of it turning negative as it did last time. Basically this is because the latest wave of capital investment spending which got under way in 1978 was deliberately designed with higher oil prices in mind, and, since corporate profits have not fallen significantly following the second oil crisis, companies have had an ample cash flow to finance a continuing stream of new investment.

The government sector, having been highly expansionary from mid-1977 through 1978 and into early 1979 has been pulling in its horns. This reaction is very similar to that of 1973-74 when there was also a contraction in the government's activity in real terms. So far as the health of the economy is concerned this trend is highly desirable: the more of the economy that is exposed to market forces in the private sector, the greater the overall level of efficiency of the economy as a whole. However, given the substantial and prolonged expansion of the government sector between 1977 and 1979 it will require several quarters of negative growth before this non-market segment of the economy is trimmed back to a proper proportion.

Finally the external sector has behaved in a very similar way to the 1973-75 period. Reflecting the strength of the yen in 1978 and the vigour of the domestic economy, import growth outstripped export growth (both in real terms) from the second quarter of 1978 to the third quarter of 1979, but as the yen depreciated in 1979 the export sector rapidly took over the leadership so that 1980 has seen a powerful export expansion despite the gradual slowdown in many of Japan's overseas markets.

In summary, Japan's response to the second oil crisis has been to cut back private consumption and government expenditure, to maintain investment in capital equipment which will make the economy more efficient and more productive in future, and meanwhile to expand exports substantially to pay for the higher relative cost of imports. Despite the weakness in consumer spending and the restraint on government spending, the strength of exports has enabled the overall GNP to remain quite buoyant

so far. In the case of both consumer spending and in the case of imports and exports it can be argued that the changes in behaviour have largely been induced by price changes:

- Consumer price increases have exceeded wage increases so that consumption spending has suffered.
- Imports have been cut back as Japan has tried to reduce its consumption of high cost oil and raw materials, a process assisted during 1979-80 by the depreciation of the currency which raised the yen prices of these items even more.
- Exports clearly benefitted substantially from the depreciation of the yen, but they also benefitted from the relative slackness of consumer spending at home which encouraged some companies to concentrate more on foreign markets than on the home market.

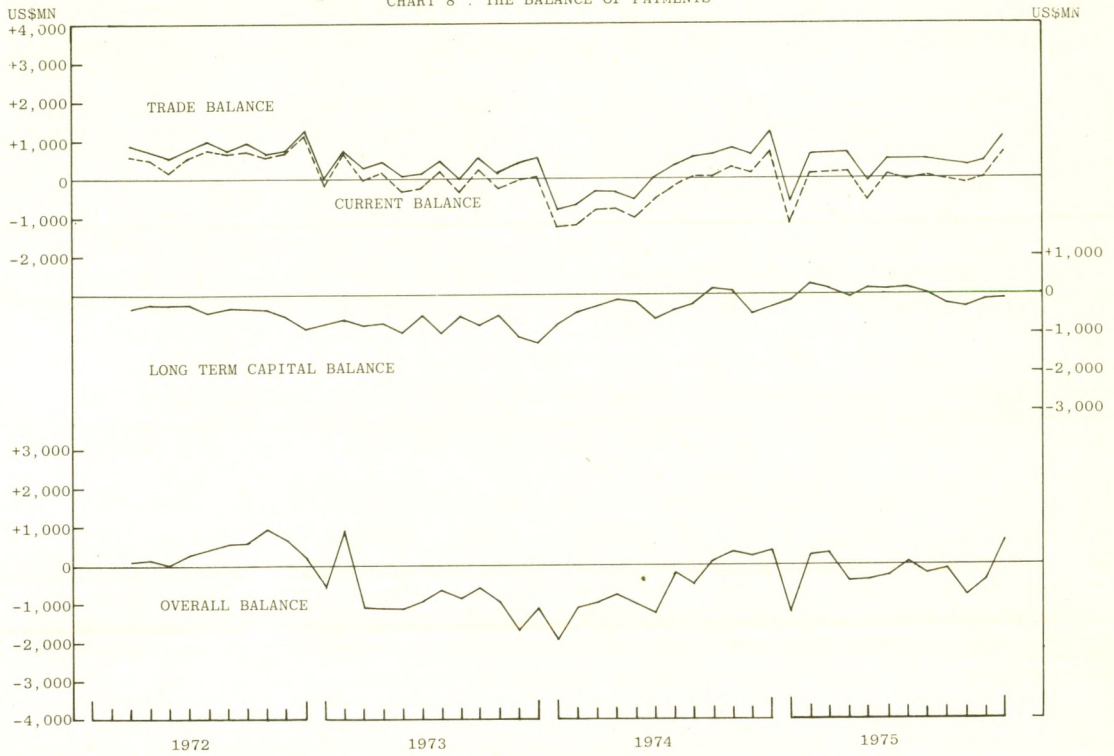
In addition it should be mentioned that the Japanese authorities have not resorted to price controls as they did at the time of the first oil crisis. At that time price controls were imposed on a wide range of over 100 commodities, not so much with a view to ensuring a gradual adaptation to the new price structure, but rather because the authorities believed that price controls would dampen inflationary expectations. (In fact the controls had almost precisely the opposite effect. Producers held back supplies from the market while consumers attempted to hoard as much as they could obtain whenever the goods appeared in the stores. As a result shortages were aggravated and public discontent ran very high.) Because price controls were not introduced at the time of the second oil crisis, patterns of consumption and production were given the maximum opportunity to adapt, and resources were not wasted either in excess consumption of imported goods or in inappropriate or subsidised production.

This description of Japan's adaptation to the second oil crisis leaves a great deal out of account. It does not treat the extensive measures taken throughout the private sector to economise on oil as an input and to rationalise production techniques, nor does it deal with the costs and benefits of official and private oil-stockpiling schemes. In essence such measures are micro-economic in nature, being concerned with improving efficiency in particular industries or meeting potential shortages in individual markets, whereas this analysis has only been concerned with Japan's response to the crisis at the macro-economic level.

FORECAST: Because the inflation in Japan has had such a small domestically generated component, Japan's various price indices will show sharply declining rates of inflation over the months ahead. Since monetary growth has been decelerating for the past nine months the economy is now slowing down. Therefore with the developing slackness in the level of activity the demand from businesses for short-term funds will weaken. Combined with an unexpected improvement in the reported rates of inflation, this should produce a significant decline in

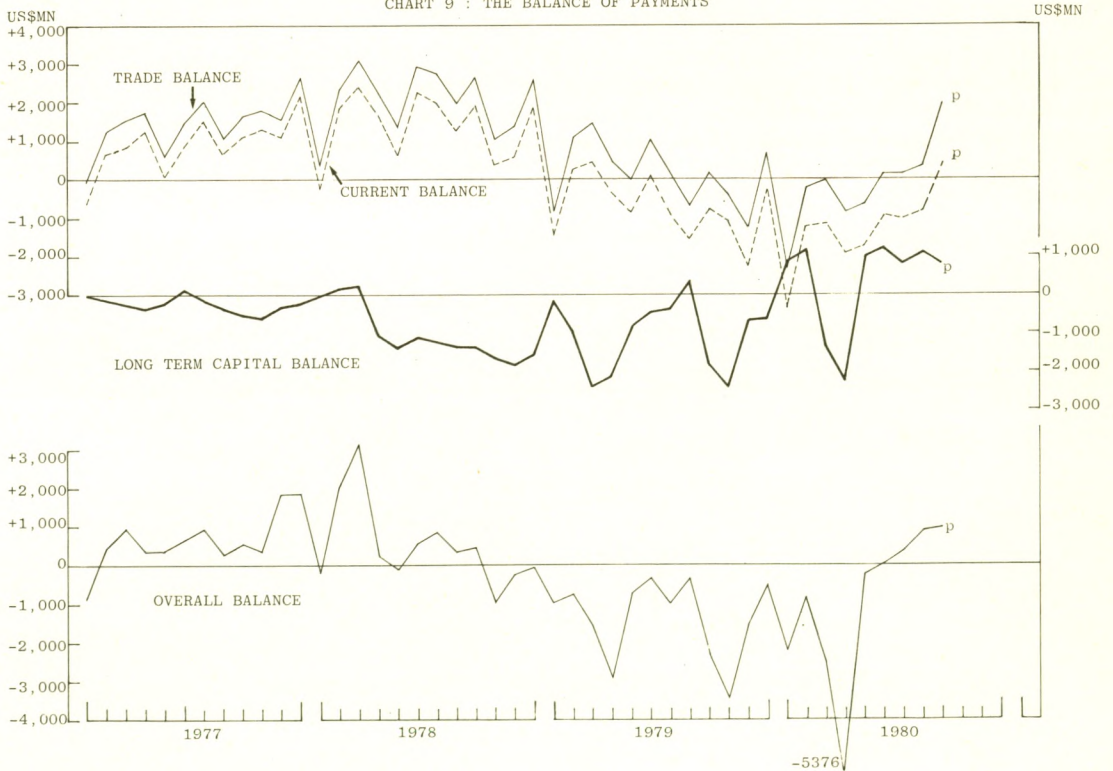
JAPAN'S RESPONSE TO THE FIRST OIL CRISIS

CHART 8 : THE BALANCE OF PAYMENTS



JAPAN'S RESPONSE TO THE SECOND OIL CRISIS

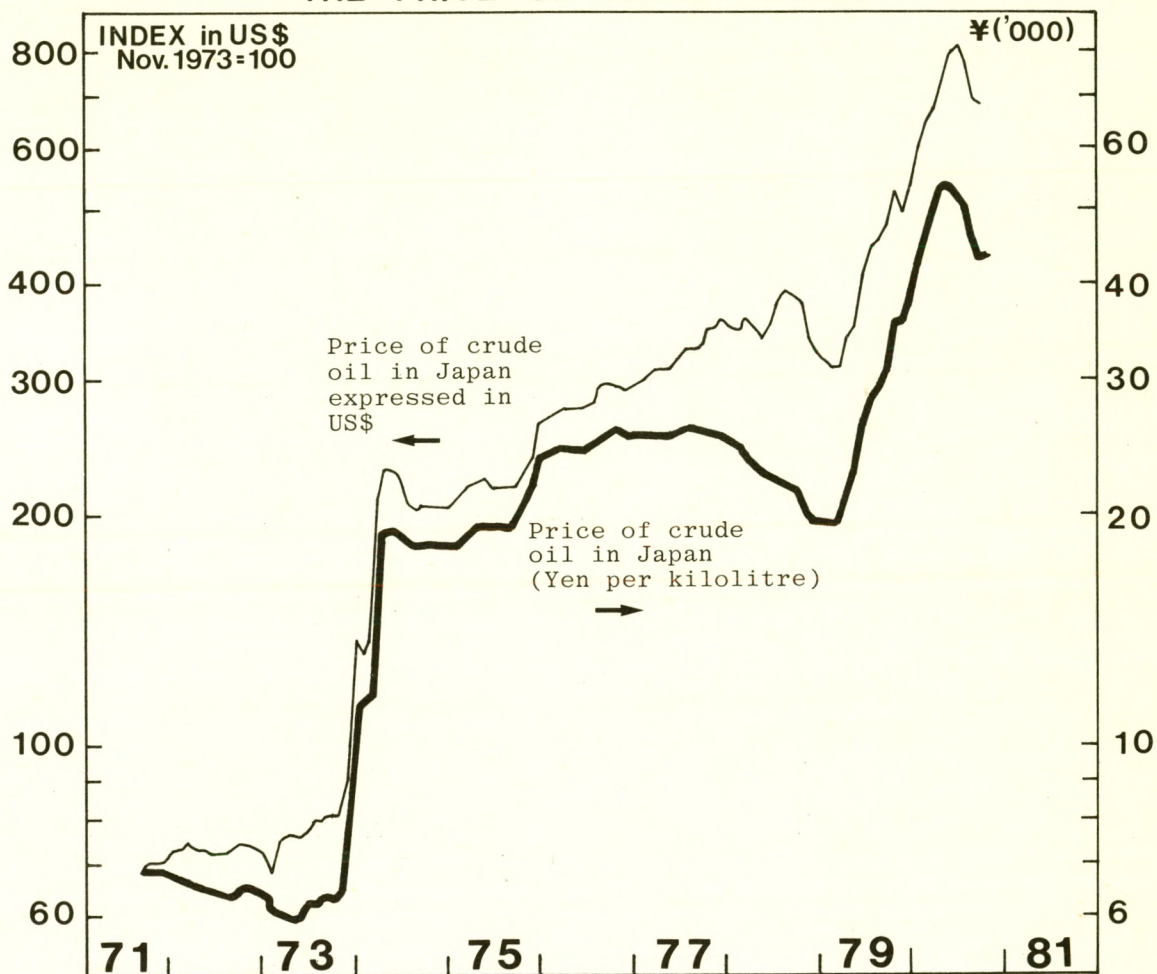
CHART 9 : THE BALANCE OF PAYMENTS



Japanese bond yields, and an accompanying appreciation in the bond market. For the international investor the problem is whether these gains from capital appreciation will be offset by any depreciation in the yen currency. Judging by the experience of recent years it would seem that currencies are strongly influenced by relative interest rates - or interest rate differentials - during periods when major central banks are deliberately tightening up and economies are slowing down, but that interest rates become far less significant when central banks have moved to an easier policy stance and the economies are generally expanding again. In the latter phases, factors such as expected inflation rates and the balance of trade (or payments) seem to become the dominant determinants of exchange rate movements. Thus whereas the sharp decline in US interest rates in April and May this year provided the background for the recovery of the yen from around ¥264 per US\$ to around ¥215 per US\$, the next major move in the yen seems likely to derive from a combination of Japan's improving external accounts and a marked decline in the reported domestic inflation rates. Even if there is some weakening in the yen due to any rise in US interest rates and/or a fall in Japanese rates during the autumn, such weakness would be short-lived. In the longer term the fact that Japan has the lowest underlying inflation rate of any OECD country almost certainly means that the yen will be the strongest OECD currency.

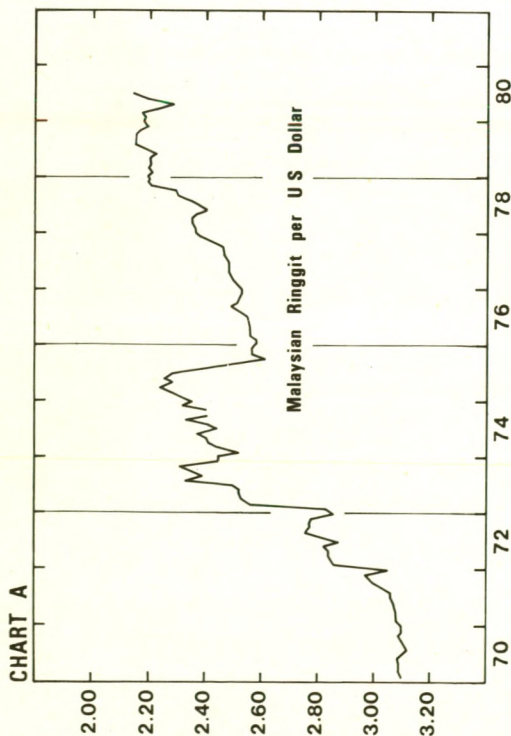
CHART 10

THE PRICE OF OIL IN JAPAN



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MALAYSIAN RINGGIT



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The currency of Malaysia, like that of Singapore, is carefully managed by the monetary authorities. The Bank Negara Malaysia (BNM), the nation's central bank, uses a trade-weighted index to monitor the overall value of the currency, but it intervenes mainly with U.S. dollars. The BNM appears to pay considerable attention to the cross-rate between the Malaysian and Singapore currencies so that in recent years these two currencies have seldom deviated by more than 2% from parity with each other.

In contrast with Japan, Korea, Taiwan and Hong Kong, Malaysia's terms of trade have improved since 1978. In other words Malaysia has benefited from the second oil crisis not only because of the rise in the price of oil (the country is a net exporter of oil), but also thanks to the increase in price of her other leading exports: rubber, palm oil and tin. At first sight everything would appear to be rosy for the currency outlook. Malaysia enjoyed a huge improvement in her trade accounts in 1979 (Chart B), international reserves soared (Chart C), and the domestic inflation rate has been low so that competitiveness improved notably in 1979 and 1980 (Chart D). However it is easy to have too much of a good thing - in this case money.

The by-product of the balance of payments surplus and the soaring international reserves has been a surge in money growth beginning in early 1979, and continuing until mid-1980. As yet the only evidence of any tightening has been the downturn in money growth in the second quarter (upper section of Chart E), and the persistent upward trend of money market rates. Inflation is picking up, but is still at a relatively low level (the CPI rose 7.2% in the year to July), and it will in any case not be a serious matter so far as Malaysia's trade-competitiveness are concerned provided the prices of her main commodities remain firm.

The recent restrictive tendency of monetary growth together with higher interest rates and Malaysia's strong international reserve position mean that Malaysia should have no difficulty in maintaining the external value of the currency, but monetary growth should be closely monitored because persistent year-to-year increases in the range 25-30% would undoubtedly undermine the strength of the Ringgit in the longer term.

M\$/US\$	Actual			Forecast	
	1980	Q2	Q3	Q4	1981 Q1
FORECAST A					
Actual Range	2.1432-2.2855			2.50	2.46
FORECAST B	2.1433-2.1531			2.16	2.14

Forecast A is based on a simple projection of relative price competitiveness shown on Chart D i.e. the exchange rate necessary to bring U.S. and local price levels into line.

Forecast B is the most likely range in the absence of some major political or other external disruption.

CHART B
TRADE PERFORMANCE

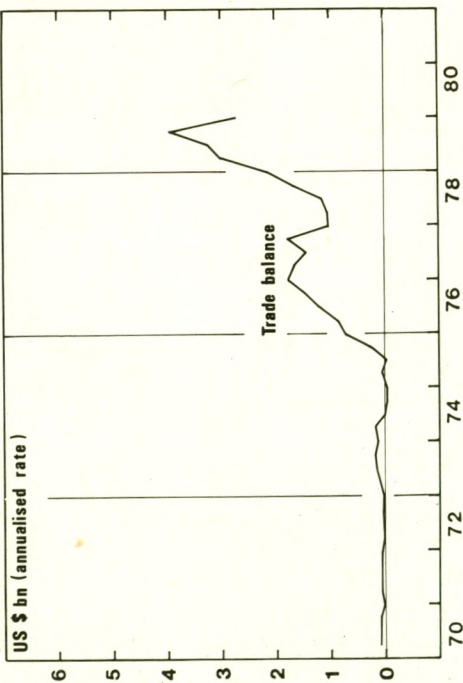


CHART C
INTERNATIONAL RESERVES

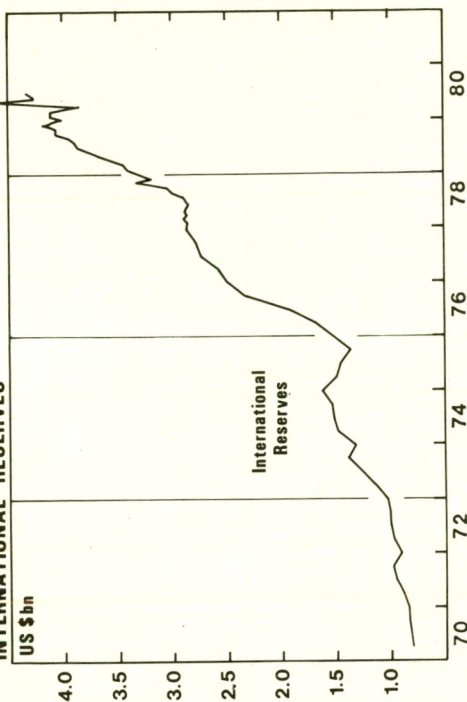


CHART D
PRICE COMPETITIVENESS (adjusted for exchange rate changes)

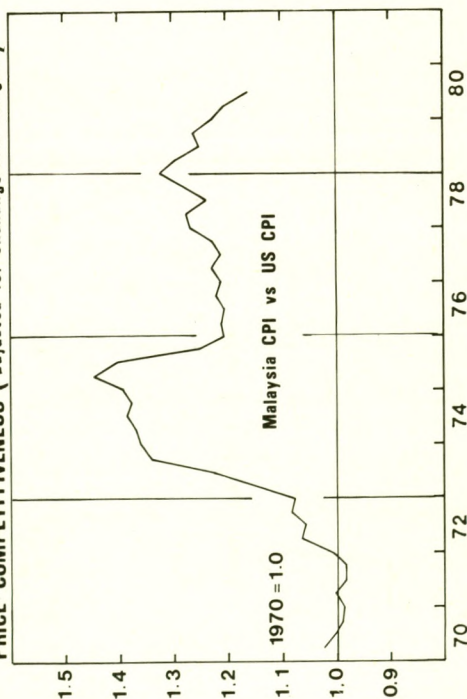
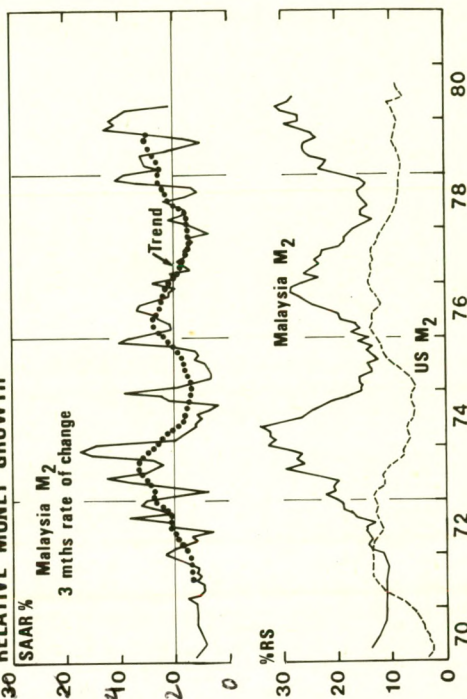
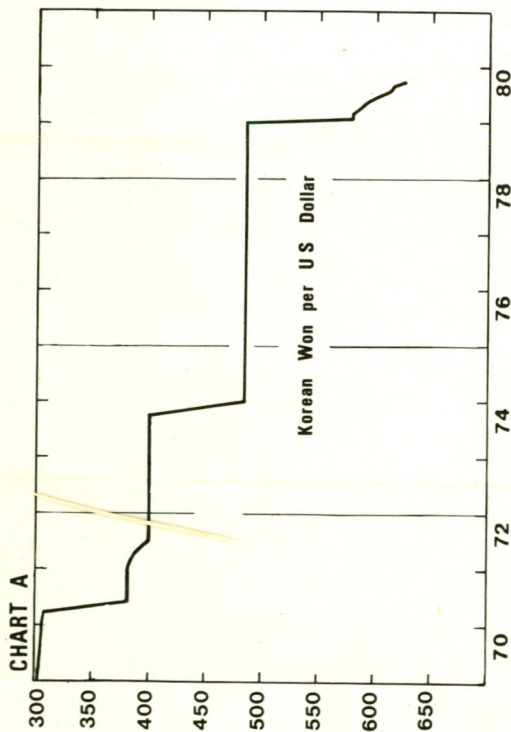


CHART E
RELATIVE MONEY GROWTH



SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

KOREAN WON



The striking deterioration in Korea's trade and current balance (Chart B) occurred in two distinct phases. The initial downturn was in 1978, and its origins were largely domestic. The economy was booming and import growth accelerated from less than 5% in the third quarter of 1977 to 55% in the final quarter of 1978. At the same time export growth was gradually slowing down. The second phase of deterioration began with the second oil crisis in early 1979, and produced a trade deficit of US\$6.7 billion (at an annual rate) in the second quarter of 1979 (Chart B). This second phase was mainly due to the adverse shift in the terms of trade because import volume had already started slowing down and - assuming the second oil crisis had not occurred - the trade balance would have improved significantly in 1979.

Despite the 16.5% devaluation of the Won in January (Chart A), and the further 8% decline in the value of the Won since the controlled float was launched on February 27th, the hoped-for export boom is not materialising. In the period January-August exports rose 17% in value, about the same as in 1978. The problem is that although exports to Third World countries such as Saudi Arabia, Kuwait, Malaysia, Thailand, Indonesia and Hong Kong have grown by as much as 50% or 60% in some cases, exports to industrialised countries have

stagnated. Sales to Japan (which normally accounts for over 20% of Korean exports) fell 12%, sales to the U.S.A. only gained 4%, while sales to Britain and Canada fell sharply.

Worse still, any improvement in the Korean trade accounts has been prejudiced by the expansionary measures announced on June 5th. The main features of this programme were an acceleration in money supply growth to 25% per annum, and an ambitious fiscal spending plan. In an environment where inflation is still running at 30% (year-to-year increase in the CPI), this means that the possibility of Korea recovering international competitiveness without further devaluation of the currency is out of the question. The beneficial effect of the January devaluation on Korea's competitiveness shows up clearly as the downward spike in the first quarter of 1980 in Chart D. However, much of the benefit has already been eroded by the continuing upward spiral of prices since then. The process of inflation-devaluation-inflation may seem like a vicious circle with devaluation producing more inflation and hence less competitive exports, but the circle can be easily broken by deliberate monetary restraint. Slower money growth forces higher import prices to be absorbed in lower real wages or lower profits, and adjusts the composition of production and spending to match the new international price structure. More rapid money growth and the accompanying inflation delay these adjustments.

Korea's international reserves (Chart C) are sufficient to support the Won against any serious run on the currency, but given the expansionary domestic policies in force the Won will probably continue to slide downwards against the US\$.

Won/US\$	Actual			Forecast	
	1980	Q2	Q3	Q4	1981 Q1
FORECAST A					
Actual Range	603.00-590.50			1430	1470
FORECAST B					
			612.70-622.80	640	670

Forecast A is based on a simple projection of relative price competitiveness shown on Chart D i.e. the exchange rate necessary to bring U.S. and local price levels into line.

Forecast B is the most likely range in the absence of some major political or other external disruption.

CHART B
TRADE PERFORMANCE

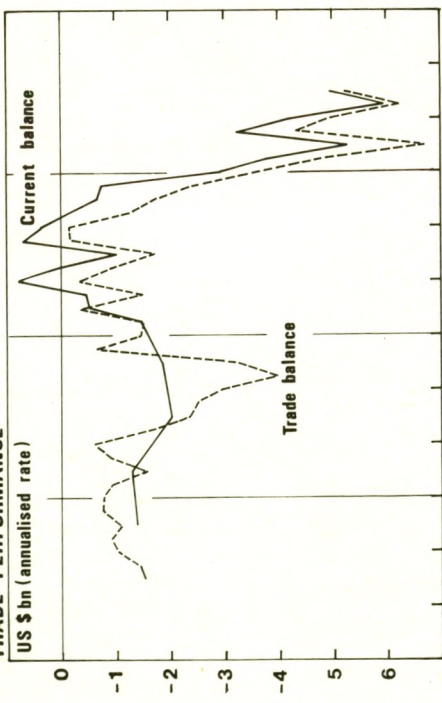


CHART C
INTERNATIONAL RESERVES

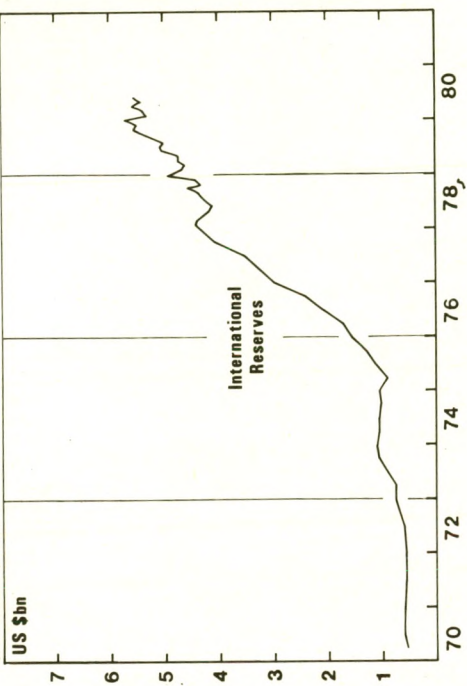


CHART D

PRICE COMPETITIVENESS (adjusted for exchange rate changes)

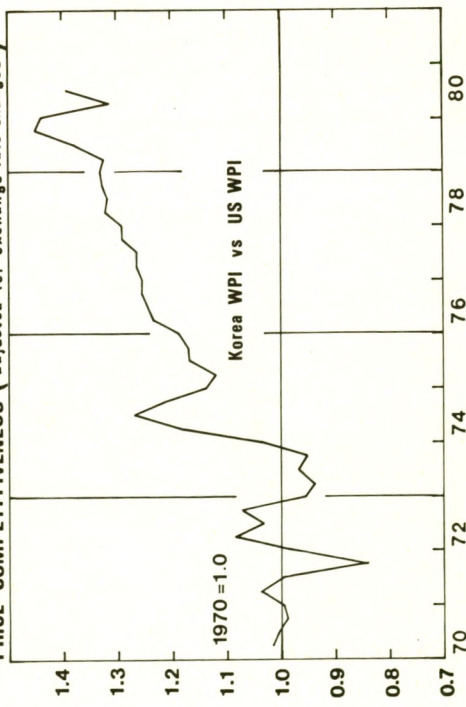
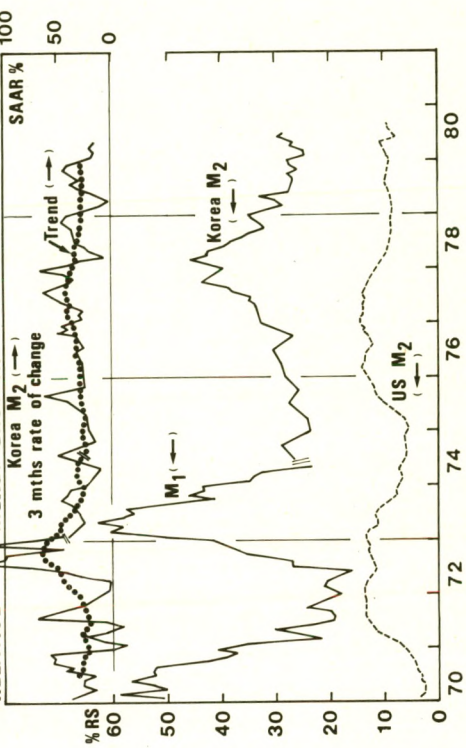


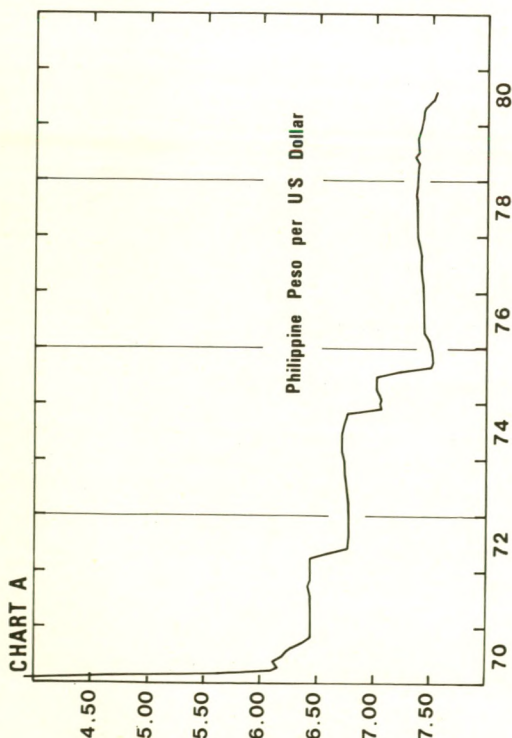
CHART E
RELATIVE

MONEY GROWTH



SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE

RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR



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The Philippine peso has experienced a series of step-like devaluations against the US\$ in the 1970s. In February 1970 the currency was devalued by 36% and by a further 5.3% by November; in early 1972 it was devalued by 5.1%; in late 1974 it was devalued by 4.4%; and in July-August 1975 it was devalued by another 6.6%. Between September 1975 and December 1979 the rate was held steady between ₱7.35 and ₱7.45 per US\$, but more recently it has been allowed to slide again. In December last year the rate fell from ₱7.36 to ₱7.42, and then again in April and May it slid from ₱7.43 to ₱7.55.

The background to each of these devaluations has differed in terms of minutiae, but looked at from a more distant perspective there is a common thread: excessive growth of money and domestic demand leading to persistent balance of payments weakness. The mechanism is a fairly standard one in ambitious LDCs. First the Central Bank decides to increase its assistance to the agricultural or manufacturing sector by making special cheap funds available to that area of the economy either through quasi-government banks or by issuing a new monetary instrument. Next, to ensure that interest rates do not rise, the Central Bank expands its lending programme. The loans made to specific sectors do not boost that sector for very long. Wages have to be paid, new fertilisers or capital equipment

have to be purchased, and additions are made to inventory in advance of the anticipated expansion. Very soon the new funds designated for the originally selected sector have spread out and percolated throughout the economy, adding to generalised spending power. While additional spending by favoured sectors may be regarded as desirable or healthy, the more general spending by other firms or individuals cannot be controlled or directed, so that before long aggregate spending including spending on imports is sharply up and inflation is beginning to rear its ugly head. The balance of payments weakens, leading foreign investors and lenders to lose faith in the currency, and local residents start trying to move capital out of the country.

Chart E illustrates the tendency of Philippine money growth to outstrip US money growth through the mid-70s. In 1979 the Central Bank finally managed to bring the growth rate down, but at the same time the country's oil import bill soared causing a deterioration in the trade balance (Chart B). Since 1976 the Philippines' inflation rate has exceeded that of the USA (Chart D), and on this basis the currency is substantially overvalued. How then does one account for the rise in international reserves shown in Chart C? Basically these figures are an accounting fiction: they show the country's gross foreign assets rather than its net position. The Central Bank's foreign liabilities in July were equal to 93% of foreign assets, compared with almost 98% in April, so the country is now past the crisis point. However the narrow margin of foreign assets over foreign liabilities will limit the Central Bank's ability to ease up. The 1979 squeeze is still largely intact - i.e. interest rates have not come down below 15-16% and money growth has been reasonably well contained - so that for the time being the series of mini-devaluations should cease.

₱/US\$	1980	Q2	Q3	Q4	1981 Q1
FORECAST A					
Actual Range	7.4280-7.5280	7.5290-7.5655	10.80	11.00	
FORECAST B					
				7.59	7.62

Forecast A is based on a simple projection of relative price competitiveness shown on Chart D i.e. the exchange rate necessary to bring U.S. and local price levels into line.

Forecast B is the most likely range in the absence of some major political or other external disruption.

CHART B
TRADE PERFORMANCE

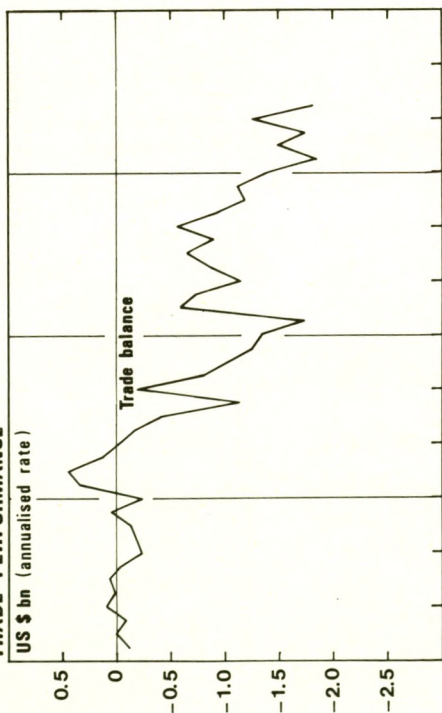


CHART C
INTERNATIONAL RESERVES

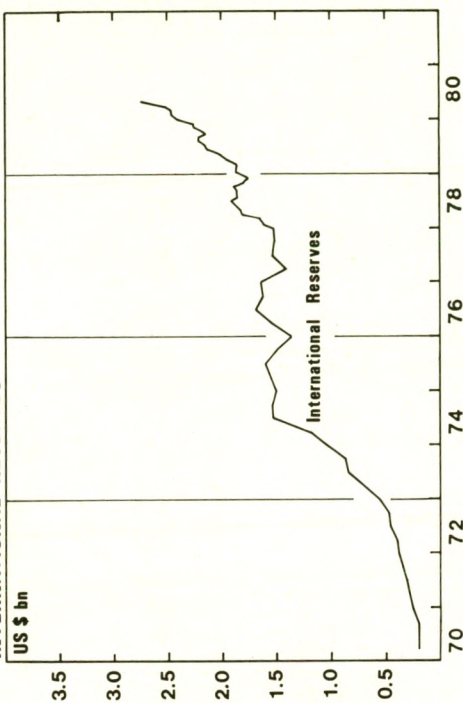


CHART D
PRICE COMPETITIVENESS (adjusted for exchange rate changes)

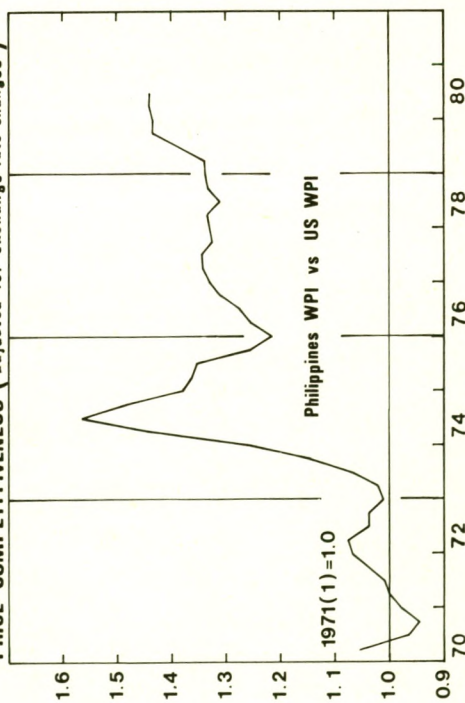
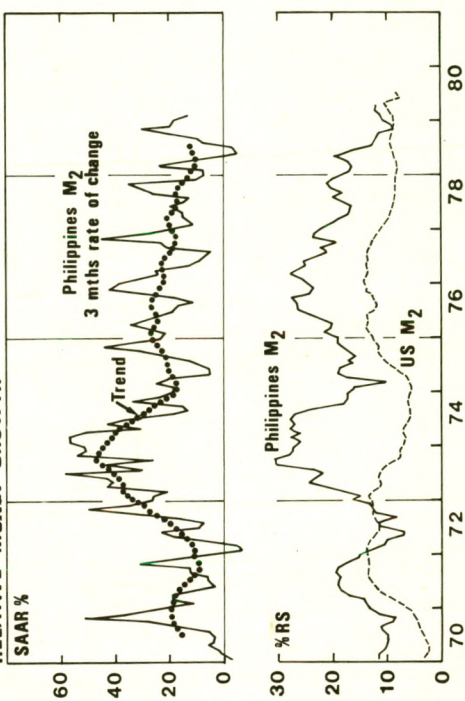
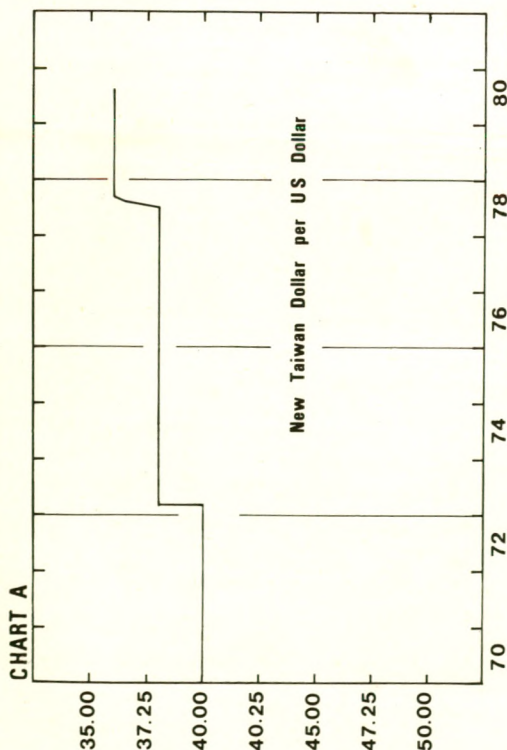


CHART E
RELATIVE MONEY GROWTH



SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

NEW TAIWAN DOLLAR



On a quarterly basis Taiwan's trade accounts slipped into deficit in the second quarter (Chart B). This deficit comes after a prolonged period of improvement in the external accounts dating back to 1974 and the time of the first oil crisis. Thanks to the build-up of trade and current account surpluses in recent years together with the sharp monetary squeeze imposed in 1979 (Chart E), Taiwan has been able to finance the second oil crisis without too much difficulty.

The clamp-down on money growth in 1979 brought in its train a sharp contraction in industrial production which has resulted in a moderation in import growth. Taiwan imports 99% of its oil requirements, and imports of oil have risen from less than 5% of imports in 1973 to nearly 25% in the current year. Like Japan, Taiwan has been fairly successful in economising on energy use with energy consumption per unit of real GNP dropping substantially in the first half of the year.

The main worry for Taiwan is the high current rate of domestic inflation and the resulting deterioration in competitiveness which is eroding export growth. The origins of the inflation are to be

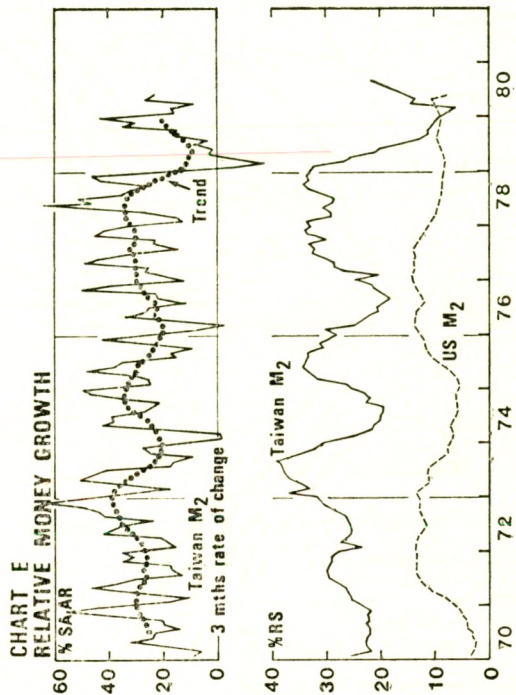
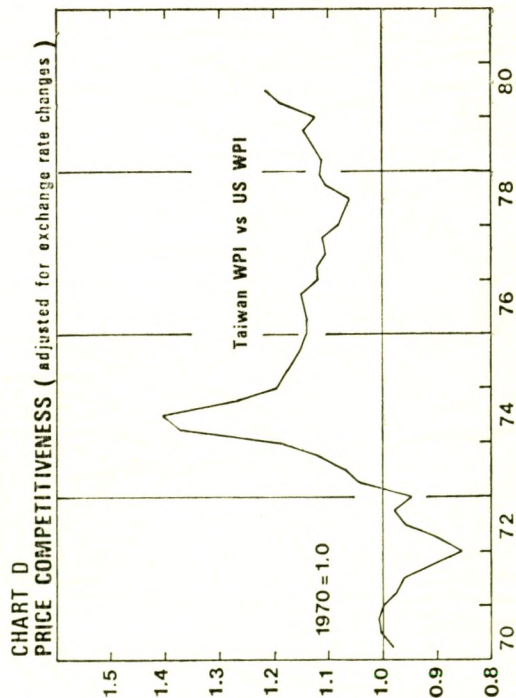
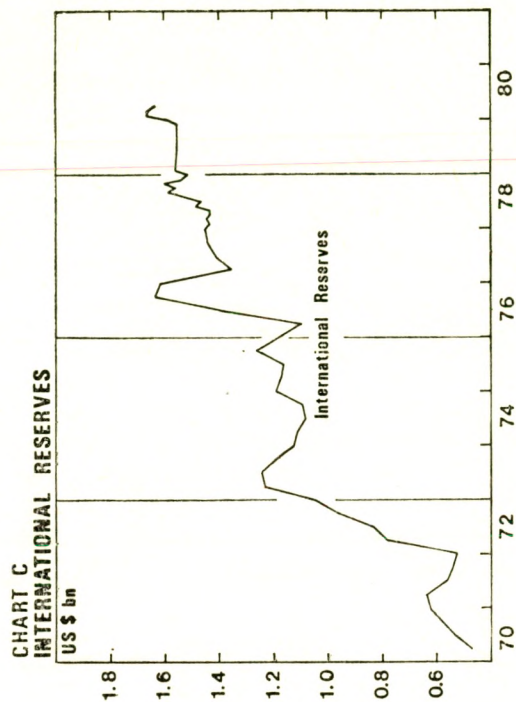
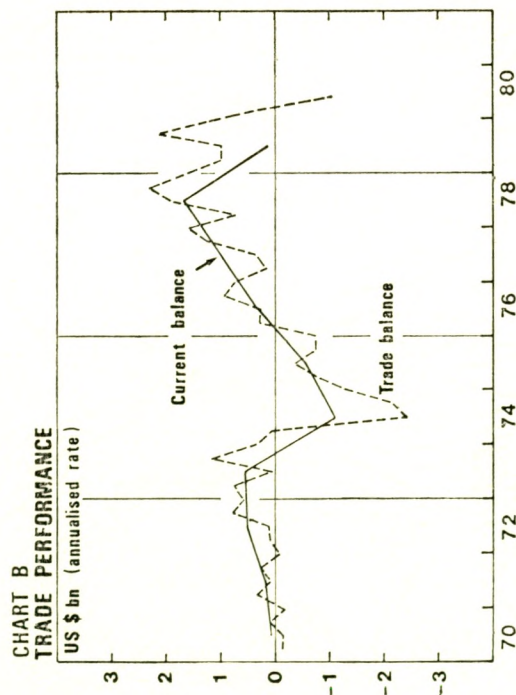
found in the extraordinarily high rate of money growth in 1977-78 which is still showing up in steep wage increases and a generalised cost-price spiral. The acceleration in money growth in the early part of this year is unfortunate because instead of squeezing inflation out of the system the current stance of policy is helping to accommodate the on-going wage hikes. The deterioration in Taiwan's competitive position (Chart D) reverses the trend of the period 1974-78 and means that the authorities will have to work hard to bring down inflationary expectations.

Taiwan's international reserve position is strong, but now that the country is more politically isolated it will be more difficult to attract international loans. Private firms and banks are of course still able to borrow funds internationally, but it will be most important that the national finances are maintained in a healthy condition in future. Any diversion of funds to shore up the balance of payments would undoubtedly be a misallocation in Taiwan's new circumstances. From this standpoint it would be logical to expect the N.T.\$ to be more flexible in future than it has been in the past. The next few months will be a testing time for the currency.

NT\$/US\$	Actual			Forecast	
	1980	Q2	Q3	Q4	1981 Q1
FORECAST A					
Actual Range					
FORECAST B					

Forecast A is based on a simple projection of relative price competitiveness shown on Chart D i.e. the exchange rate necessary to bring U.S. and local price levels into line.

Forecast B is the most likely range in the absence of some major political or other external disruption.





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EDITORS:

John G. Greenwood

M.A. (Hons) Econ. Edinburgh
Research Economist, University of Tokyo
Economist at G.T. Management (Asia) Ltd.

Christian Wignall

B.A. Econ. Cambridge
Economist at G.T. Management (Asia) Ltd.

Hugh Sloane

B.A. Econ. Bristol
M. Phil. Econ. Oxford
Economist at G.T. Management (Asia) Ltd.

**CHARTS AND
STATISTICS:**

S.Y. Chan
Michael Wong

ADMINISTRATION:

Isabella L.Y. Ling

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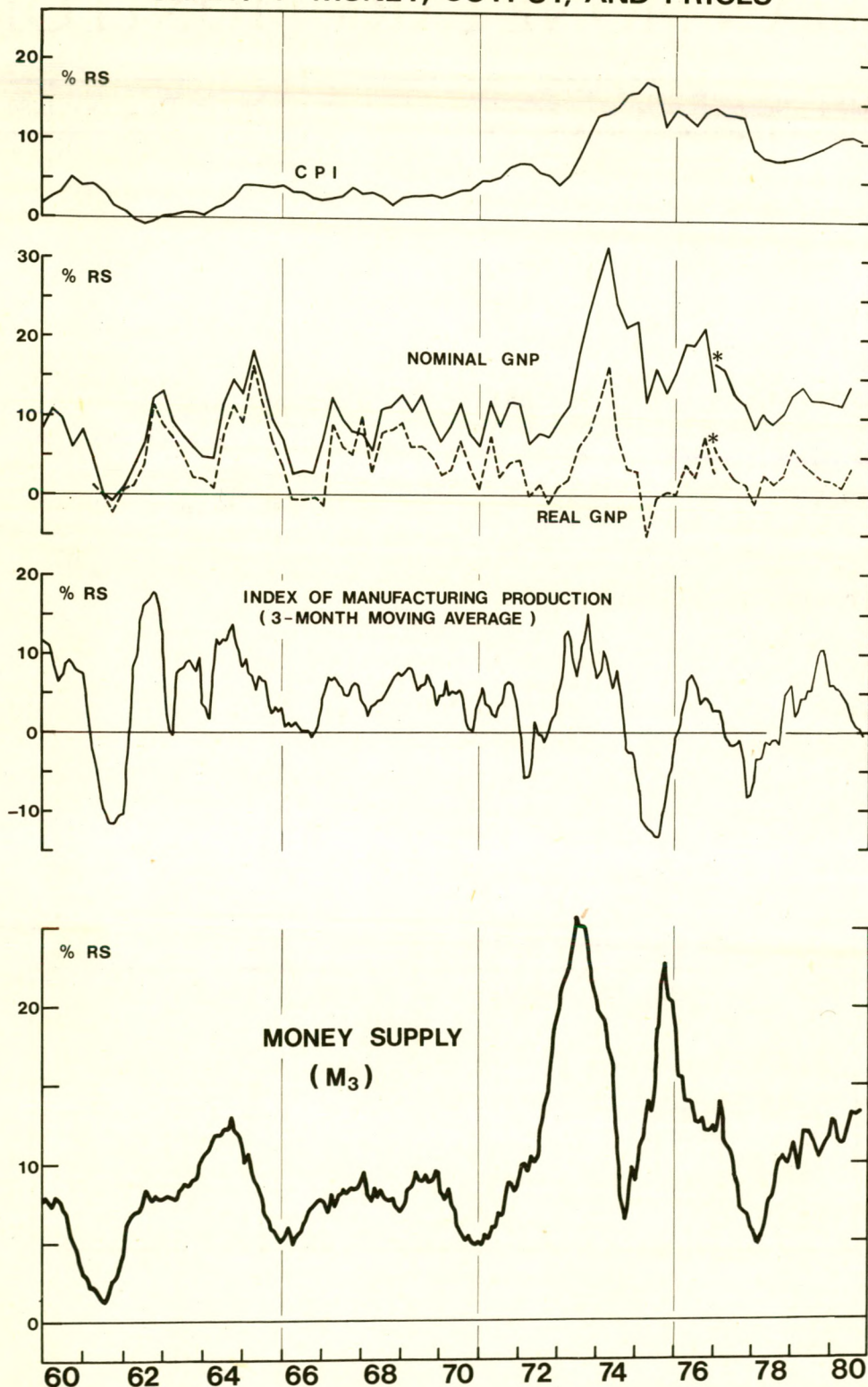
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KEY TO SYMBOLS USED IN THE CHARTS

- % RP** - Percentage Rate of change over Preceding period.
% RS - Percentage Rate of change over Same period of preceding year.
SA - Seasonally Adjusted.
SAAR - Seasonally Adjusted at Annualised Rate.

AUSTRALIA

CHART 1 : MONEY, OUTPUT, AND PRICES



*Change of data series.

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AUSTRALIA

THE BALANCE OF PAYMENTS AND THE BASKET

On the 31st December, 1980 the Australian dollar reached a two year high against the US dollar of A\$1=US\$1.1807. The last time the Australian dollar was substantially above its present level occurred in November 1976 in the period immediately before the currency was devalued by 17.5% against a trade weighted basket of currencies. At that time the Australian dollar bought 1.225 US dollars, and was then devalued to 1.015 against the US currency on November 28th, 1976.

Before examining the factors behind the current strength of the Australian dollar, it is worth tracing the changes in the Australian authorities' exchange rate policy during recent years. At the Smithsonian Agreement in December 1971 the forty year old direct link between the Australian currency and sterling was severed* and was replaced by a formal link with the US dollar at a parity of A\$1=US\$1.216. With persistent trade account and balance of payment surpluses during 1971, 1972 and 1973 it soon became obvious that the Australian dollar was undervalued against a weakening US dollar. Nevertheless the Australian authorities maintained a formal peg with the US dollar. This was in contrast to the Japanese and most European central banks which decided to allow their currencies to float after the US dollar was devalued for the second time in February 1973. The Australian policy necessitated three revaluations of the domestic currency, which reached a record level of A\$1=US\$1.4875 in September 1973. In retrospect, as is indicated by the trends in both the current account and trade account in Charts 2 and 3, the Australian dollar was clearly overvalued by the beginning of 1974. The overvalued currency contributed to the very severe recession during 1974 and 1975 which the authorities attempted to alleviate through a 12% devaluation against the US dollar in September 1974.

Although it should by now have been clear to the Australian authorities that their method of pegging their currency to the US dollar merely exacerbated swings in the domestic business cycle, the revised policy initiated just after the September 1974 devaluation offered little improvement. Instead of having a fixed link with the US dollar, the Australian dollar was pegged to movements in the weighted average of a group of currencies. Details of the components of the "basket" and of the weightings attached to each currency were kept confidential, presumably in an effort to reduce speculation against short term exchange rate fluctuations. The important element of this new policy was that the trade weighted value of the Australian dollar remained constant for the two year period up until November 1976. In other words the basket system, as it operated in practice, was still effectively a fixed rate response, rather than a component of a coherent overall policy designed to ensure

* The Australian dollar had not suffered a parallel devaluation with sterling in November 1967. Instead the Australian dollar was revalued from £1=A\$2.50 to £1=A\$2.14, but the formal peg to sterling was retained.

non-inflationary real growth. During the September 1974-November 1976 period it is by no means clear what the intended objective of Australian exchange rate policy actually was. A comparison of Charts 1 and 2 suggests that the fixed basket rate was too high relative to the Australian inflation rate if the aim of exchange rate policy at that time was to encourage a healthy current account position. Conversely it appears that the fixed rate basket method also failed if it was intended to force a reduction in domestic inflation through an external drain on liquidity. If this was indeed the objective of exchange rate policy during the period it would have been better to maintain the domestic currency's fixed rate to the US dollar since the Australian dollar actually depreciated from A\$1=US\$1.325 in September 1974 to A\$1=US\$1.225 in September 1976.

In fact, the real problem was that Australian domestic and external economic policies failed to complement one another during this period. If the authorities had maintained both the "high" basket exchange rate and a contractionary domestic stance, the improvement in the current account and inflation during 1975 would almost certainly have continued.

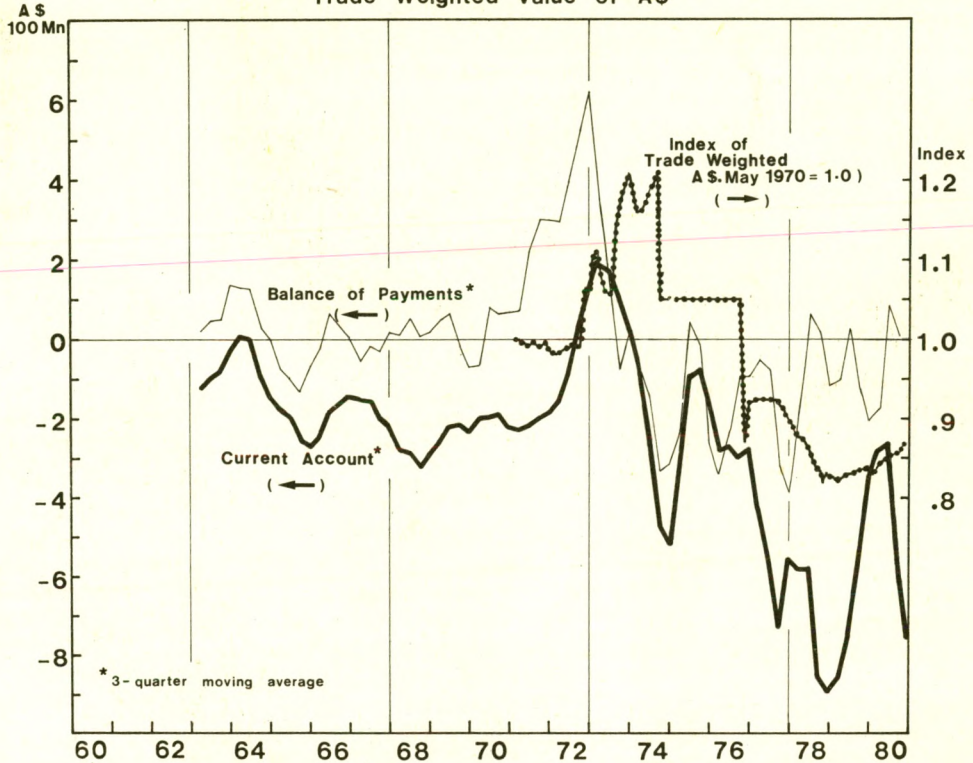
Instead they pursued an aggressively expansionary domestic policy during 1975, with the result that Australian inflation remained high relative to its trading partners. As a consequence the Australian dollar was under severe downward pressure from both a weakening current account and a high level of consumer price inflation.

After the November 1976 devaluation, Australian exchange rate policy was altered once again, such that, ostensibly, it could respond to domestic policy requirements. As it turned out, the combination of domestic and external policy measures during the 1977-1979 period were almost exactly the opposite of those imposed during the fixed basket rate regime. Instead of reflating the domestic economy whilst at the same time maintaining a "high" exchange rate, the Australian authorities gradually reduced the trade weighted value of the Australian dollar and at the same time squeezed the domestic economy (compare Charts 1 and 2) during a period when virtually all of Australia's trading partners were reflating. In due course the policies were reflected in an improvement in both Australia's current account and its relative inflation rate.

The most spectacular improvement in Australia's economic condition occurred in its trade account. From a roughly balanced position at the end of 1978, a rapid growth in export volumes (see Chart 4) bought about a record trade surplus by the fourth quarter of 1979. With the current account also improving and Australia's inflation relatively low in comparison with many of its OECD competitors it was widely asserted that the Australian dollar was undervalued. Large private capital inflows during the summer of 1980 were, to a degree, consistent with this view, which was apparently vindicated by the slight appreciation of the trade weighted index (see Chart 2) and the Australian dollar's firmness against the US dollar in the last nine months of 1980.

AUSTRALIA: CHART 2

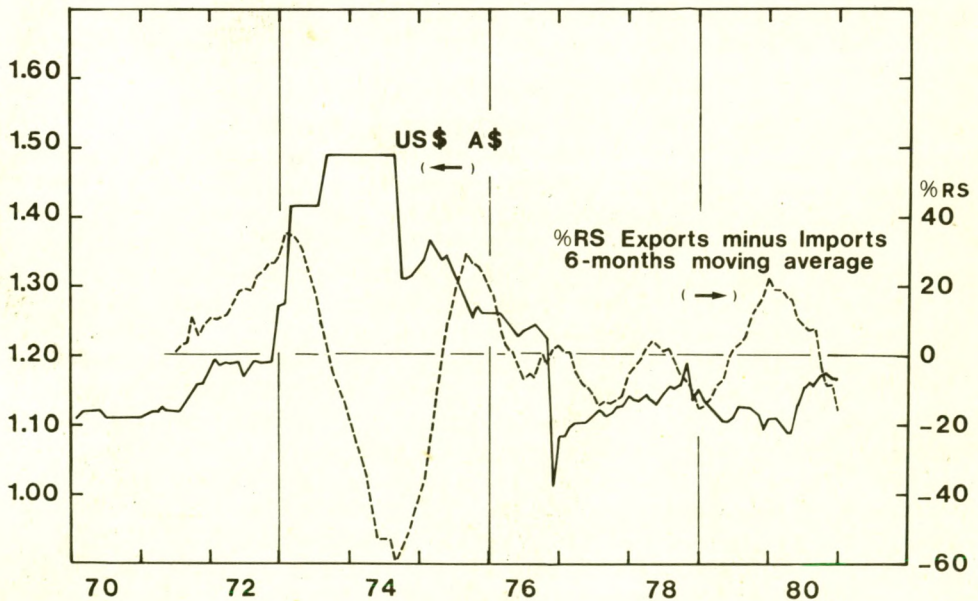
Current Account, Balance of Payments and
Trade Weighted Value of A\$



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AUSTRALIA

Chart 3 : The Trend in the Australian Trade Account



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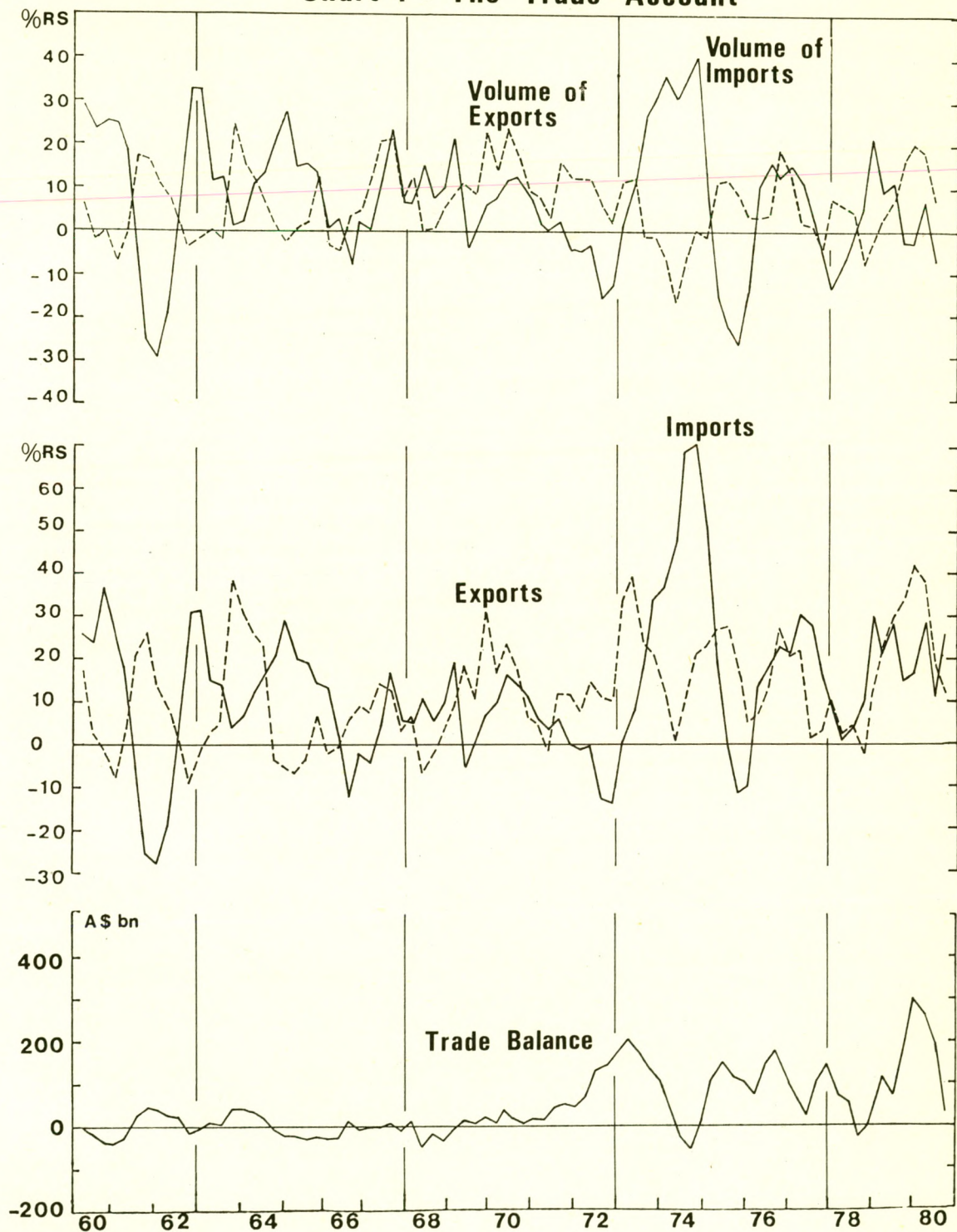
Nevertheless the view that the relative strength of the Australian dollar against the US dollar is confirmation that the former was "undervalued" should be treated with suspicion. With the managed basket exchange rate policy, the Australian authorities are faced with two basic decisions. First they need to assign appropriate weights to each component currency of the basket. Although the authorities are secretive about the weightings and the methods for formulating them it is probably reasonable to assume that each weighting is kept constant in the short to medium term. Second the authorities must decide on an appropriate intervention policy for guiding the trade weighted exchange rate as part of overall economic policy. Once the weightings for each currency in the basket have been set, it is clear that the two basic decisions are independent of one another, at least in the shorter term. It follows therefore that, even though the Australian dollar remained firm in the face of record US interest rates during November and December 1980, its performance against the dollar is no proof that it was undervalued during much of last year.

Chart 5 suggests that the Australian dollar's performance against the US dollar stems primarily from the Australian authorities' first decision; in other words it suggests that both the yen and sterling have relatively high weights in the basket of currencies which the Australian dollar is measured against. It is clear from Chart 5 that one could have successfully inferred the A\$/US\$ rate from accurate projections of the strength of the yen and sterling. Undoubtedly there are other currencies in the authorities' basket but Chart 5 suggests that the US dollar, sterling and the yen have the most important weightings. This would be consistent with Australia's basic trade pattern. In fiscal 1980 Japan, the US and the UK accounted for 28%, 14% and 7%, respectively, of Australia's total exports. The very close relationships evident in Chart 5 indicate beyond reasonable doubt that the Australian dollar's strength against the US dollar is primarily a result of the basket exchange rate policy, rather than any fundamental strength.

Of course the fact that the Australian dollar has appreciated against the trade weighted basket of currencies has exerted additional upward pressure on the A\$/US\$ rate, and prevented greater weakness against the yen. However it seems unlikely that there will be very much further appreciation in the Australian dollar against the trade weighted index during 1981. The Australian economy is entering the final stage of the current business cycle later than its major trading partners. Liquidity in the domestic economy still shows little sign of slowing down (see Chart 1) and nominal GNP growth remains high. As a consequence domestic demand, and inflationary pressures, remain relatively high in comparison to other OECD countries. This has resulted in a sudden reversal in Australia's trade account (see AMM Vol. 4 No. 3) where import growth has remained firm in response to continued growth of domestic demand whilst export growth has declined along with worldwide economic activity. Australia's current account deficit is now close to its record level at the end of 1978. This is unlikely

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Chart 4 : The Trade Account



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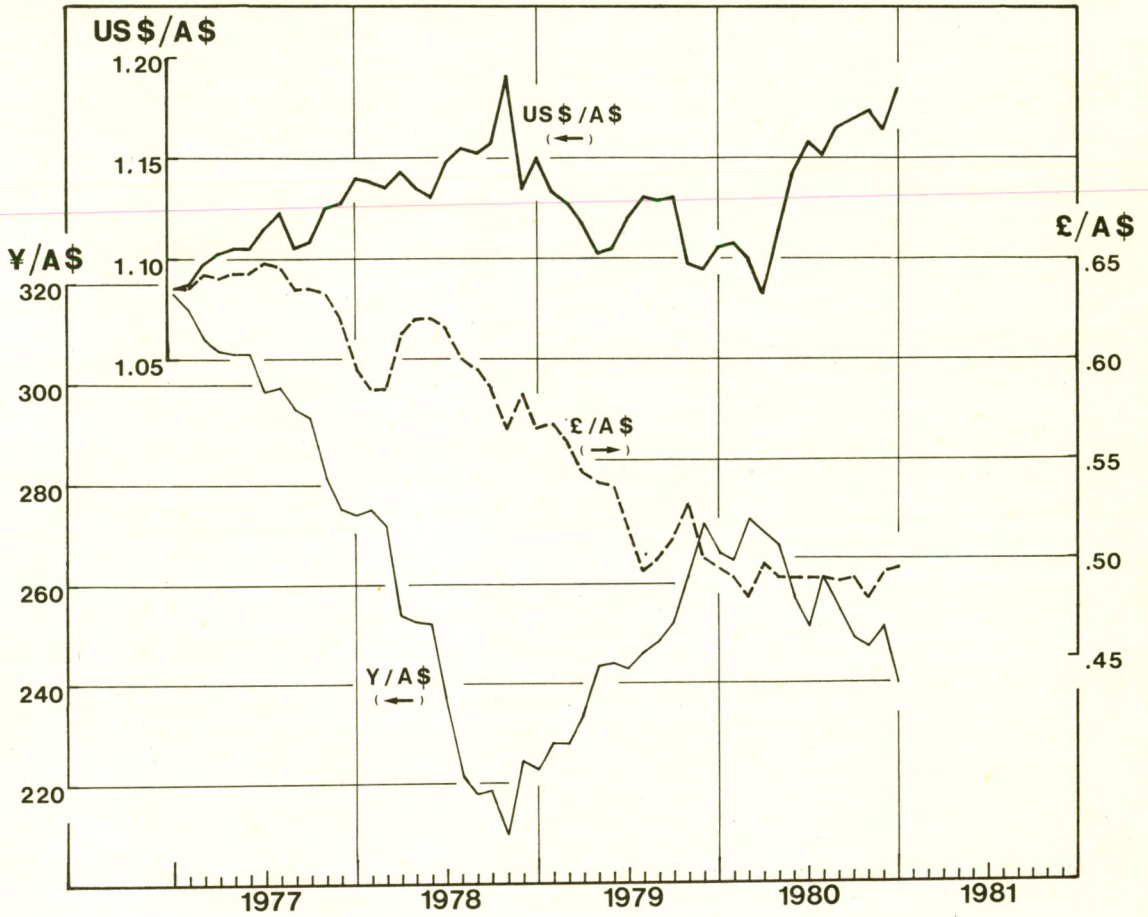
to show any sign of improving whilst domestic liquidity growth remains at current levels.

FORECAST: The Australian dollar appears to be entering a period where its underlying economic circumstances are broadly comparable to those that existed in 1975 and 1976. The trade weighted index is overvalued relative to the actual and prospective level of domestic inflation. The trend in the balance of trade account and the sharp deterioration in the current account are both evidence for this view. Large private capital inflows, which are required to finance resource exploitation projects, do not change the fundamental picture for the external account. Moreover, as in 1975, the Australian monetary authorities are not as yet following policies reliably designed to restrict domestic liquidity growth. The external account is thus likely to continue under pressure. In view of such circumstances we would be surprised to see any further appreciation in the trade weighted value of the Australian dollar. Indeed, some depreciation is more likely.

Nevertheless it is possible that the Australian dollar will continue firm against the US dollar during the first half of 1981. On the evidence of Chart 5 this will occur if the yen continues to be the world's strongest currency, and providing sterling remains around current levels. However, any appreciation against the US dollar will, primarily, be a reflection of the fact that the Australian dollar is managed against a basket of currencies which are themselves strong against the US dollar. Firmness against the US dollar is not a good indicator of any fundamental strength of the Australian dollar.

AUSTRALIA : CHART 5

The Australian Dollar against the U.S. Dollar, Sterling and Yen



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JAPAN

THE IMPACT OF INTEREST RATE LIBERALISATION

Since the Bank of Japan began to focus its attention on controlling the money supply in the mid-1970s, one necessary consequence has been that the external exchange rate for the yen has had to become more flexible. Another necessary consequence, which has accompanied the new policy is that interest rates have also had to become more flexible. In the October edition of Chosa Geppo, the Bank of Japan's research bulletin, there is an important survey of the resulting developments in Japan's money markets. In particular the survey explores some of the consequences of interest rate liberalisation over the past three or four years.

The impact of interest rate liberalisation in the financial markets can be analysed in three parts - the effect (1) on the structure of the money markets, (2) on the transmission of monetary policy, and (3) on the behaviour and profitability of Japanese city banks.

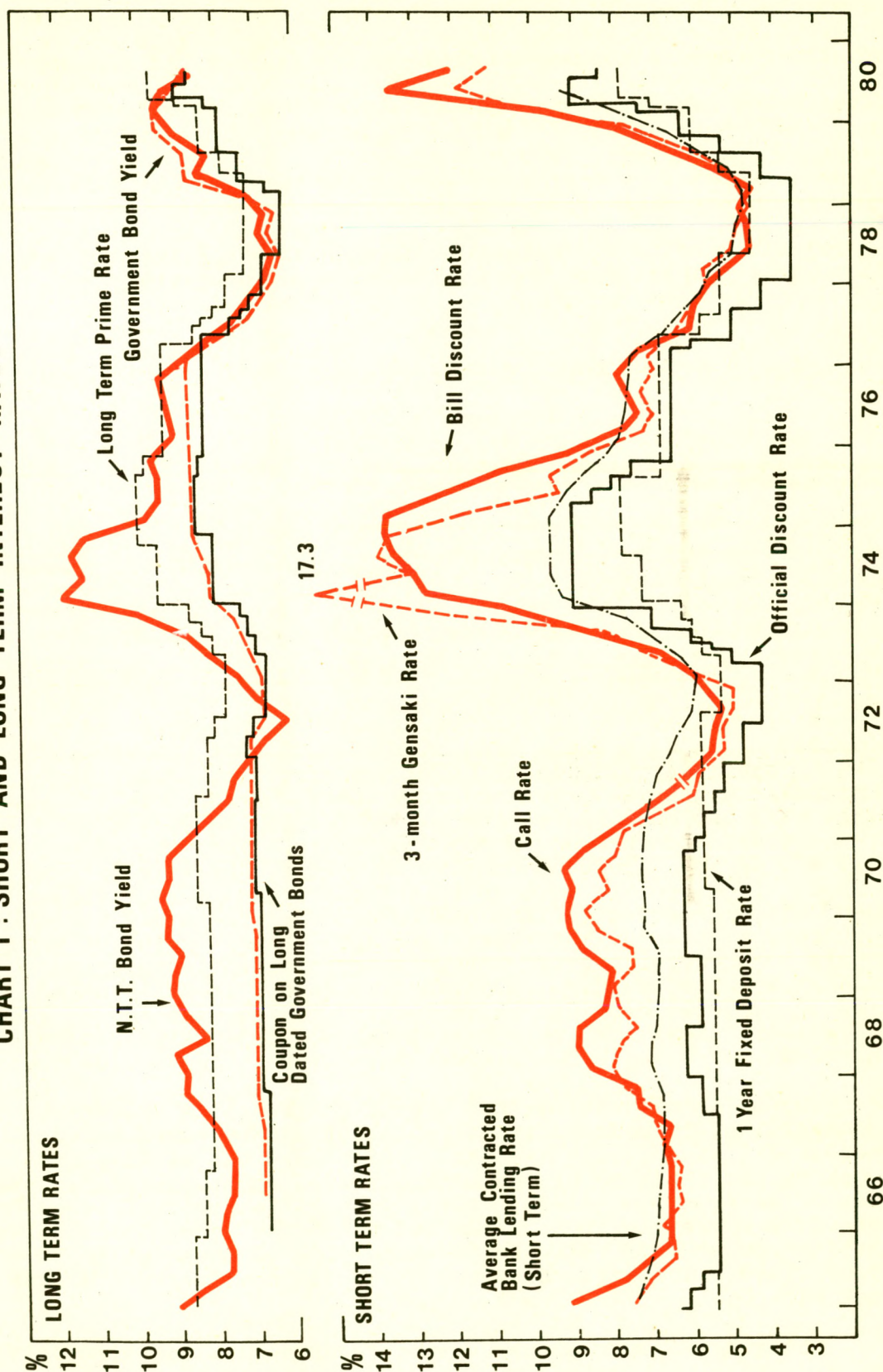
(1) CHANGE IN THE STRUCTURE OF THE MONEY MARKETS

Table 1 below sets out a chronology of steps taken by the Bank of Japan to achieve greater flexibility of interest rate

TABLE 1 : CHRONOLOGY OF INTEREST RATE LIBERALISATION

<u>Market</u>	<u>Date</u>	<u>Action</u>
Call Market	June 1978	Finer gradations introduced in official quotations for call rate movements.
	October 1978	Free market introduced for 7-day rates.
	April 1979	Free market introduced for rates less than 7-days. Official quotation system abolished.
Bills Discount	June 1978	Intermediate re-sale of bills purchased permitted.
	November 1978	Rate on 1-month bills freed; 3 and 4-month rates liberalised.
	October 1979	Official quotation system on 2-month bills abolished.
Gensaki Market	January 1979	Restrictions on financial institutions funding themselves through gensaki market eased.
	May 1979	Restrictions on non-resident transactions in the gensaki market eased.
Certificates of Deposit	May 1979	Free market in CDs began: the only restrictions were on quantity of issues.
Free Yen Deposits	March 1980	Interest payable to foreign official organisations liberalised.

JAPAN
CHART 1 : SHORT AND LONG TERM INTEREST RATES



movements. It should be remembered that in deregulating interest rates the Bank of Japan is frequently in opposition to other branches of government such as the Ministry of Finance (which has sought to keep the coupon on government bonds at rates below market equilibrium rates) and the Ministry of Posts and Telecommunications (which has been responsible for setting interest rates on Postal Savings Deposits) in proposing these changes, so that each of these steps can be viewed as a modest victory by the Bank of Japan within the bureaucratic system.

Table 2 below indicates the change in the pattern of fund flows in the short term money markets in recent years.

TABLE 2

SHORT TERM MONEY MARKETS (Yearend volume outstanding; ¥ trillion)

	Interbank Call Market	Bills Discount Market	Gensaki Market	CD Issues
1974	2.2	5.2	1.7	-
1975	2.3	4.4	1.8	-
1976	2.6	5.1	2.1	-
1977	2.6	6.1	3.1	-
1978	2.3	6.6	4.2	-
1979	3.5	6.3	4.0	1.8
June 1980	2.5	5.5	4.7	3.0

Historically the call market was the most active and volatile of Japan's short term markets. This is the market between banks in which local banks and agricultural savings institutions generally lent to city banks. Traditionally city banks were the most aggressive lenders among the banks, and frequently found themselves short of funds. They therefore borrowed in the interbank markets to lend to their industrial customers. Since the rate of interest charged or received on every other component of the banks' balance sheets was strictly regulated it was the interbank call rate which fluctuated most widely. As one of the few unregulated rates reflecting the true pressure of supply and demand for funds, it acted as a kind of residual pressure valve for the system as a whole. The table above shows that this market has not grown significantly in recent years while new markets have grown up alongside it.

The bills discount market - a market in which prime commercial bills and export bills discounted by banks - has been in existence since the early 1970s, and was given a major boost by the decision of the Bank of Japan to start rediscounting such bills from June 1972. Until June 1978, however, no secondary market in these bills was permitted, and it was not until November 1978 that the rates payable on these bills were liberalised. The bills discount market is now substantially a free market.

The gensaki or repurchase market was for a long time only given grudging acknowledgement by the authorities but has

gradually become increasingly important as a source of short term funds for a wide variety of financial institutions as well as industrial corporations. In this market holders of long or medium-dated bonds sell these instruments and simultaneously repurchase them at a future date, usually within one to three months. In part the unwillingness of the authorities to issue short-dated instruments equivalent to Treasury Bills at market rates has contributed to the development of this market; the persistent tendency to issue long-term bonds has burdened the financial system with a huge supply of long term assets, so in order to meet short-term financing requirements market participants have responded by developing a mechanism which enables them to convert long term assets into short term liquidity. Although the repurchase rates in the gensaki market have been substantially free, there have been very definite restrictions on who may participate in this market. Only in May 1979 for example did it become properly legitimate for non-residents to participate in gensaki transactions, although prior to that transactions could in fact be arranged via Japanese subsidiary companies overseas.

Finally, the CD (Certificate of Deposit) market has been in operation since May 1979. Although this method of raising funds by the banks is unrestricted as to the interest rate that may be offered, and in that sense is a fully competitive market, there are still restrictions on the size and amount of individual bank's issues of CDs, and there is still no secondary market in CDs. As they are not negotiable instruments, in principle they have to be held to maturity. The short-sightedness of this arrangement is evident in the fact that a gensaki or repurchase market in CD's has already begun to develop to enable investors to liquidate their holdings prior to maturity if they so desire.

In calling any money market a 'free' market one must be careful to distinguish between (i) explicit regulation of rates and (ii) central bank pegging of a rate. In the first case specific laws or regulations or official guidance may dictate that rates for any particular instrument be set at $x\%$ p.a. or not more than $y\%$ p.a. This type of regulation will have the effect of distorting the flows of funds between lenders and borrowers - in some instances denying borrowers any access to funds at all. In the second case the central bank may decide to participate in one particular market, supplying or withdrawing funds until the market rate reaches the level desired by the authorities. To keep the rate in question at this level the central bank will necessarily have to supply or withdraw funds from the money market, a policy which will soon cause the money supply to deviate from its intended target. Thus the results of explicit rate regulation will be quite different from the case where a central bank dominates a market by its size or through continuous intervention. In the case of explicit rate regulation borrowers and lenders will be forced to find alternative methods of matching each others' needs; in the case of central bank rate-fixing by continuous intervention all prices in the economy will be forced to adapt to the one price that is being pegged. This latter case of the authority trying

to peg an interest rate is analogous to the case of an authority trying to peg the external exchange rate between its currency and any other. Sooner or later the contradiction between the consequences of its persistent intervention (i.e. a significant acceleration or deceleration in monetary growth) will require some readjustment of rates. Just as a non-equilibrium exchange rate cannot be maintained indefinitely, a non-equilibrium interest rate also has to be corrected in time.

In the case of Japan's money markets today a number of regulated rates remain, and their extent and significance should not be underestimated, but they are not such as to disrupt the implementation of monetary policy. The important point is that the Bank of Japan has abandoned the attempt to peg rates on a persistent basis. From time to time the Bank of Japan may appear to control rates in the money markets (just as it appears to control exchange rates when it intervenes from time to time in the foreign exchange markets), but this intervention is more an apparent restriction than a real one because the intervention is necessarily temporary given the overriding importance of the Bank of Japan's money supply targets.

The main effect of the remaining regulatory or institutional controls on specific deposit interest rates or lending rates is to shift funds from one group of institutions to another or to favour one group of lenders or borrowers relative to another. This type of distortion is evident in Japan in the recent shift of funds from the banking system to the postal savings system, and in the preference shown to large-sized depositors and borrowers compared with small firms or individuals. This kind of shift of funds between different financial institutions and hence between different monetary aggregates is of far less importance than any disruption to monetary growth that might be produced by the Bank of Japan seeking to peg short term interest rates at some particular level.

In view of the distortions to fund flows induced by the remaining rigidities of the interest rate structure the authorities are now faced with a clear challenge: either to extend interest rate liberalisation and thereby (i) improve the allocation of funds by ending discrimination between financial institutions and (ii) improve the transmission of monetary policy influences through interest rates, or face further continuing distortions to the pattern of fund flows. The Bank of Japan favours extending interest rate liberalisation because it would facilitate the transmission of monetary policy in a non-discriminatory and more predictable fashion. On the other side the Post Office and the Ministry of Posts and Telecommunications have fought a rearguard action claiming that it is not merely because interest rates at the Post Office are higher that depositors like to place their funds there. In recent weeks a 5-man arbitration committee has been set up to study the problem and is due to report sometime during the summer of 1981. However even assuming the committee reaches a clearcut decision it will not be easy to change the status quo.

(2) THE TRANSMISSION OF MONETARY POLICY

The liberalisation of interest rates has led to an upsurge in arbitrage transactions between the various different short-term money markets. In addition, tightness or ease in the short-term markets has been transmitted along the yield curve to the longer term markets for credit. But it is not only the freeing up of controls on interest rates which has encouraged arbitrage between markets. By removing the restrictions on which institutions could participate in particular markets the authorities have opened up previously sheltered markets to competition from all comers.

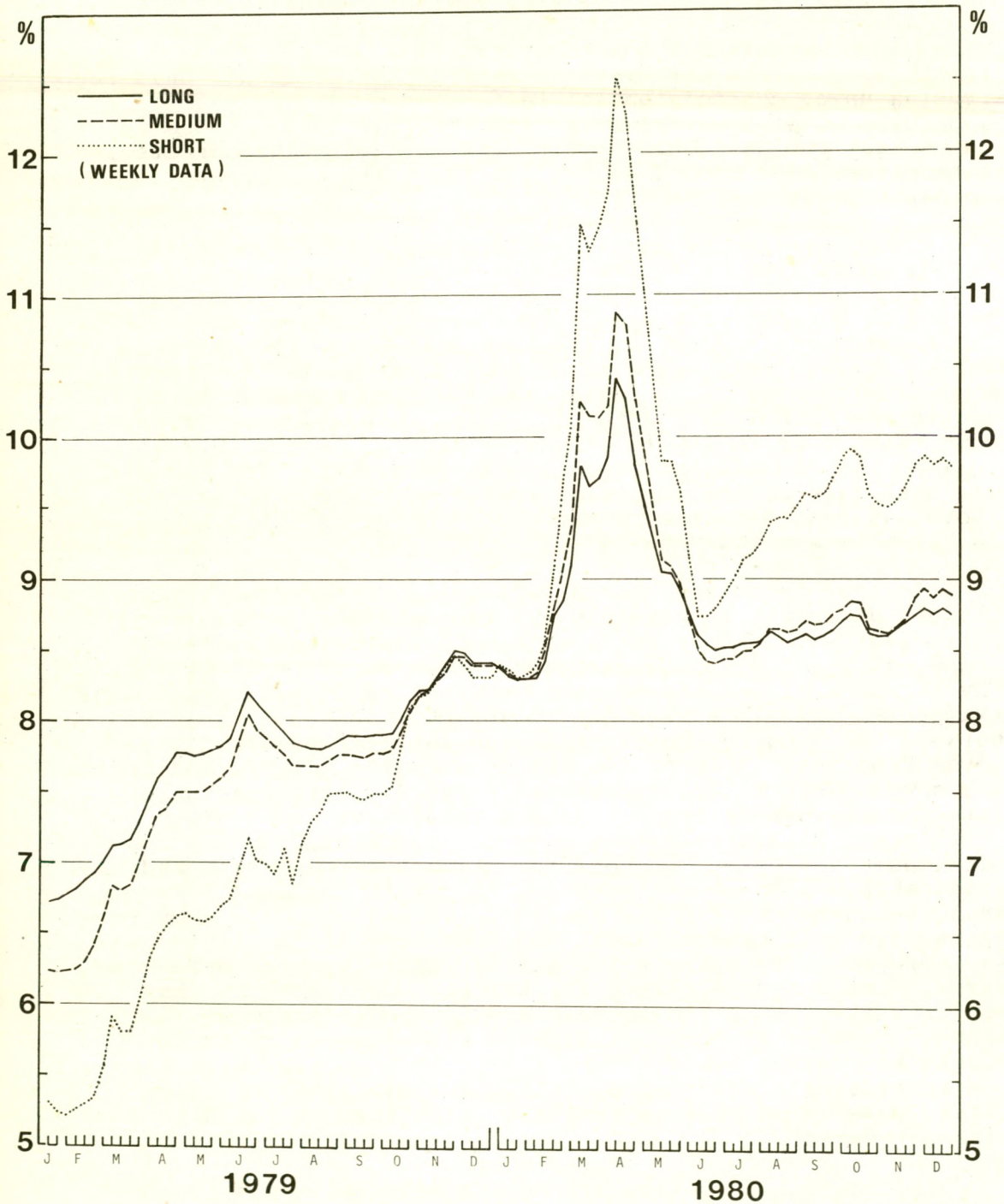
Therefore in the latest tight money period from April 1979 to September 1980 there has been a notable change in the behaviour of interest rates as compared with the preceding period of monetary stringency from January 1973 to March 1975. The greater willingness of the authorities to allow market forces to determine rates meant that despite the fact that in the latest period of restraint the relative slowdown of money growth was much less and the inflation rate was much lower, some rates rose to levels almost as high as in the 1973-75 period. In the case of the bills discount rate, for example, the peak rate in the preceding period of restraint was just above 14%, while in the latest period of restraint it rose to 13.6875% in May and June 1980.

Another important change reflecting improved arbitrage between different instruments was the much more consistent pattern of movement of rates of similar maturity this time compared with the wide divergences which were characteristic of the highly artificial conditions in past credit squeezes. For example in 1973-75 a huge gap of 400-600 basis points opened up between the 3-month gensaki rate and the bills discount rate (over 2-months), both on the way up as rates climbed and on the way down. This time, by contrast, official intervention or interference was minimal, and as a result the gap between 3-month money market rates was very small - usually below 100 basis points. Chart 3 shows the 3-month gensaki rate and the comparable bill discount rate together with the new CD rate (new, because CDs were not issued in 1973-75). Only when rates started to fall between April and June 1980 did a significant gap open up between the bills discount rate and the other two rates. The probable reason for the gap opening up at that time was that throughout the squeeze most corporations were fairly liquid; as soon as they anticipated a decline in rates they sought to acquire money market assets at high yields (buying CDs or placing bonds in the gensaki market) thus forcing a rather more rapid decline in these rates than in the bills discount market.

The increased flexibility of interest rates has improved the transmission of monetary policy in several respects. First, the increased ability of firms and individuals to arbitrage between debt instruments of different maturities along the yield curve has strengthened the linkage between short-run funding costs and long run funding costs. When rates

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CHART 2 : NIKKEI GOVERNMENT BOND YIELD INDICES



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rose at the short end of the yield curve these short-term funding pressures were conveyed along the yield curve so that not only did shorter term investment opportunities appear less favourable, but certain longer term projects were also rendered less attractive. In the past the tendency was for virtually all longer term funding to be cut off during a squeeze so that aggregate capital investment was liable to wide fluctuations as the funds available to invest were alternately switched on and off. Now Bank of Japan tightening impacts the credit markets more evenly all along the yield curve. Thus the first effect has been to help to smooth out variations in the capital investment cycle, and therefore squeezes are now less discriminatory in their effects on different sectors.

Second, the wider permitted movements of interest rates almost certainly reduced the extent of speculative inventory building in the present cycle. Because nominal interest rates rose more relative to inflation in the recent tight money policy phase than in previous tight money policy episodes, the real interest cost of financing speculative inventory purchases was higher all the way through the squeeze, and hence movements of indicators such as the inventory/sales ratio have remained much more subdued through the latest episode of tight money than on previous occasions.

Third, it is possible that wider variations in nominal interest rates have encouraged more switching both among financial assets and between financial assets on the one hand and tangible assets on the other. This means that Japanese savers now have a greater opportunity than before to protect themselves against the erosion of the real value of their assets. In the past the rigidity of the interest rate structure meant that many individuals could not respond to changes in the financial environment and were forced to accept substantial real losses as market interest rates (e.g. the gensaki rate) and inflation rose above the regulated rates on their deposits. Therefore not only do shifts in Bank of Japan policy affect businesses and individuals through altering the absolute availability of loans, but firms and individuals can now respond by shifting their portfolios more actively than was ever possible in the past in response to changes in BOJ policy.

All these changes imply that the announcement effect of shifts in Bank of Japan policy is now more widely diffused because policy is no longer transmitted solely through quantitative channels. In the past the main avenues of adjustment were through: (i) changes in the volume of BOJ discounts to the City Banks, and (ii) changes in the volume of City Bank lending permitted by the BOJ. Both of these have now been supplemented by a variety of other instruments which affect the behaviour and responses of participants in the markets for credit. The Bank of Japan nowadays alters the reserves of City Banks not only through direct loans at the discount window but also through purchasing, selling and swap operations in commercial paper and in short-term government bonds. Although it has been possible to maintain the discount rate at a lower absolute level than other money market rates and ration the amount of funds made available

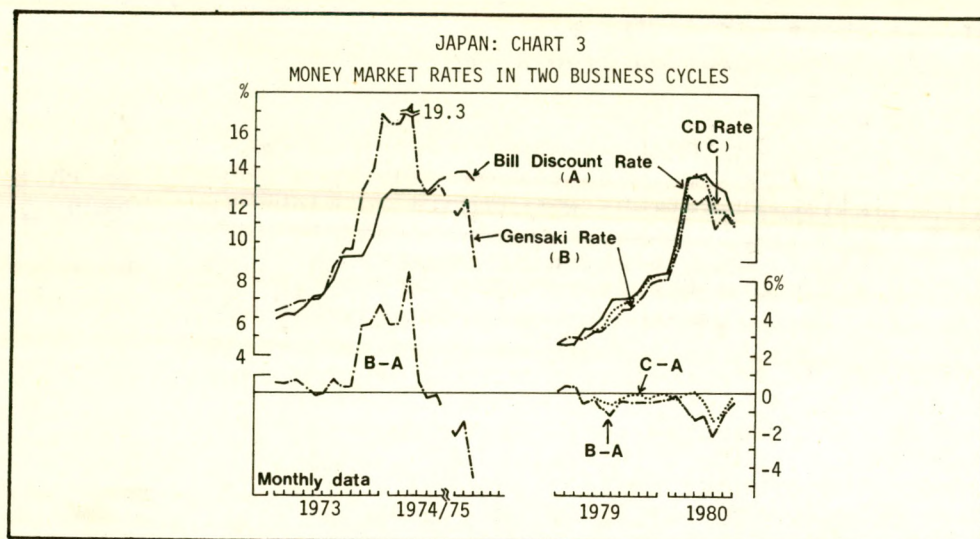


TABLE 3: CITY BANK BALANCE SHEETS

ASSETS	June 1974		June 1980	
	¥ bn	%	¥ bn	%
Cash*	4,713.2	7.8	9,154.9	8.7
Deposits at other banks**	1,127.7	1.9	2,208.4	2.1
Call Loans	76.9	0.1	932.1	0.9
Loans and Discounts	40,753.8	67.4	68,567.0	65.1
Securities	7,362.0	12.2	16,373.0	15.6
Foreign Exchange	4,409.6	7.3	5,415.7	5.1
Other	2,016.3	3.3	2,594.8	2.5
Total	60,459.5	100.0	105,245.9	100.0
LIABILITIES				
	¥ bn	%	¥ bn	%
Deposits	44,269.0	73.2	81,210.0	77.2
CDs	-	-	1,394.2	1.3
Debentures	383.0	0.6	1,355.1	1.3
Call Money	1,318.1	2.2	2,083.0	2.0
Bills Sold	4,455.6	7.4	5,222.9	5.0
Borrowed Funds	1,728.0	2.9	1,534.6	1.5
(from BOJ)	(1,524.4)	(2.5)	(1,279.0)	(1.2)
Foreign Exchange	1,348.2	2.2	1,191.7	1.1
Other Liabilities	3,886.8	6.4	6,979.3	6.6
Capital Accounts	3,070.8	5.1	4,275.1	4.1
Total	60,459.5	100.0	105,245.9	100.0

* Includes cheques in process of collection.

** Includes reserve deposits at BOJ.

through this channel, operations in short term paper have been conducted on a more impartial, free market basis by means of regular auctions. Insofar as the authorities are now conducting operations at market rates of interest they are using both a quantity effect (through changing the availability of reserves) as well as a price effect to transmit to banks the incentive to act more aggressively or with more restraint, and because of competition among the banks, these impulses are in turn transmitted to their customers.

(3) THE IMPACT OF INTEREST RATE LIBERALISATION ON CITY BANKS

Looked at from the standpoint of City Banks interest rate liberalisation has had two main sets of consequences. First it has meant a significant change in funding practices. Before liberalisation City Banks depended for the bulk of their resources on fixed term deposits. Their main sources of non-deposit funds were:

- (i) borrowing from the Bank of Japan,
- (ii) the call market, and
- (iii) the bills discount market.

Today they still depend mainly on deposits, but have the additional options of raising marginal funds from:

- (iv) issuing certificates of deposit,
- (v) selling bonds in the gensaki (repurchase) market, and
- (vi) conducting swaps in the foreign exchange market.

Items (iv) is still subject to some restriction in relation to an individual bank's capital. Also, where foreign exchange transactions are concerned - item (vi) - there are restrictions on each individual bank's net open positions in the forward market.

The relative importance of all of these new funding sources is not immediately apparent from City Bank balance sheets, but three of the changes do show up (see Table 3 opposite). The amount of money borrowed by City Banks from the Bank of Japan is down in both percentage and absolute terms from 1974. Similarly, the gross amount of money borrowed in the call market is down on a percentage of assets basis (but not on an absolute basis), and if one takes the net call market position of City Banks (Call Loans less Call Money) the absolute amount is also down since 1974.

Funds raised through the bills discount market cannot be accurately traced on bank balance sheets since City Banks as a whole may be either buyers or sellers of these instruments. Also, activity in the bills discount market is reflected in items on both sides of the balance sheet. No conclusive statement can therefore be made about the importance of this source of funds from balance sheet analysis.

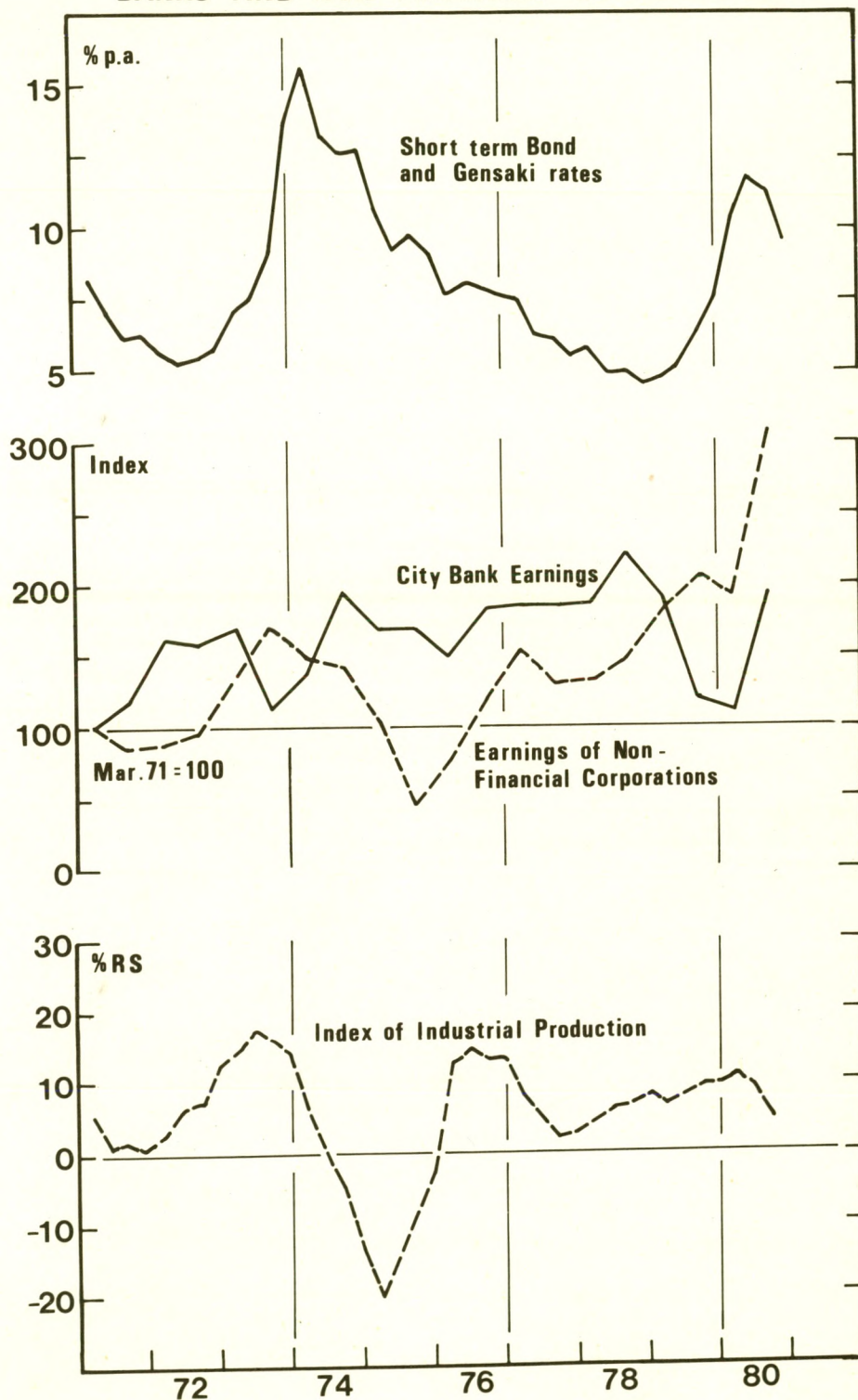
Certificates of deposit are a new item since 1974 and they now occupy a position equal in importance to the issue of bank debentures which are also twice as significant as a source of funds (on a percentage basis) as they were in 1974. The remaining two items - gensaki transactions and swaps - cannot be identified in the balance sheets so again no clear statement can be made.

It is at first sight surprising to note in the context of the growth of the postal savings system at the expense of the banks that, despite all the discussion, City Banks' deposits as a share of their total balance sheet have actually increased in percentage terms. In part this is due to the relative deterioration of their capital base; in part it reflects their reduced dependence on the call market and the Bank of Japan as direct sources of funds. (The other item contributing to this result is the reduction in "Bills Sold" which is one of the items comprising the bills discount market.)

The second main consequence of the growth of these competitive markets for funds is the erosion in the earnings and hence in the capital position of Japan's City Banks. During the period following the first oil crisis City Bank earnings suffered very little by comparison with the earnings of non-financial companies. When interest rates first began to rise in 1973, City Banks collectively suffered a sharp setback in their semi-annual results (September 1973), but thereafter recovered and maintained a level of earnings between 50% and 100% above the March 1971 level - at least until 1978/79 when interest rates started to rise again. (See Chart 4 opposite.) In contrast with the earnings of non-financial companies which were severely affected by the downturn in industrial production in 1974-75, City Banks were shielded from the oil crisis, though not from the initial effect of the upturn in interest rates in 1973.

In the recent period of tight money City Banks have suffered quite disastrously by comparison. For three successive semi-annual periods (March 1979, September 1979 and March 1980) overall net profits declined. Two main factors have been operating to produce this result, both of them a result of interest rate liberalisation. First of all whereas City Banks made steady gains from their bond portfolios throughout the period of falling interest rates from 1975 to 1978, they have lost heavily on their now substantial bond portfolios as yields have risen and bond prices have fallen in the latest tight money period. In the 1973-74 episode bank portfolios of bonds were not only smaller, but the prices of bonds were supported in the market either by outright support operations, or by official guidance which effectively prevented anyone from selling bonds thus causing the market to dry up artificially from illiquidity. It was not uncommon at that time for brokers acting under MOF guidance to refuse to carry out an order to sell. Since this comfortable prop to the market no longer exists the bond market has seen much wider price movements in the latest cycle despite lower inflation expectations and the less intense squeeze.

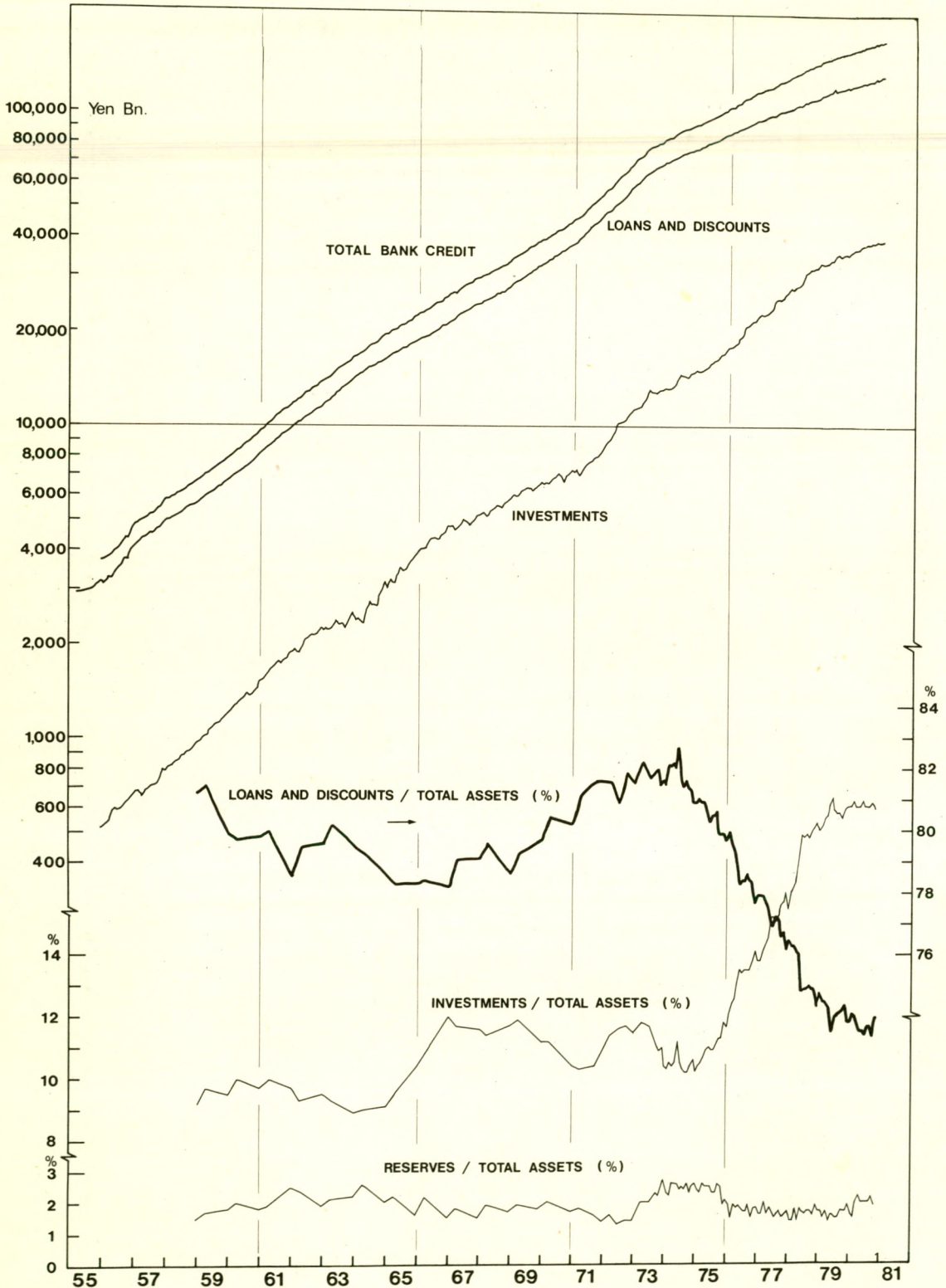
JAPAN
CHART 4: COMPARISON OF EARNINGS OF CITY
BANKS AND NON-FINANCIAL CORPORATIONS



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JAPAN

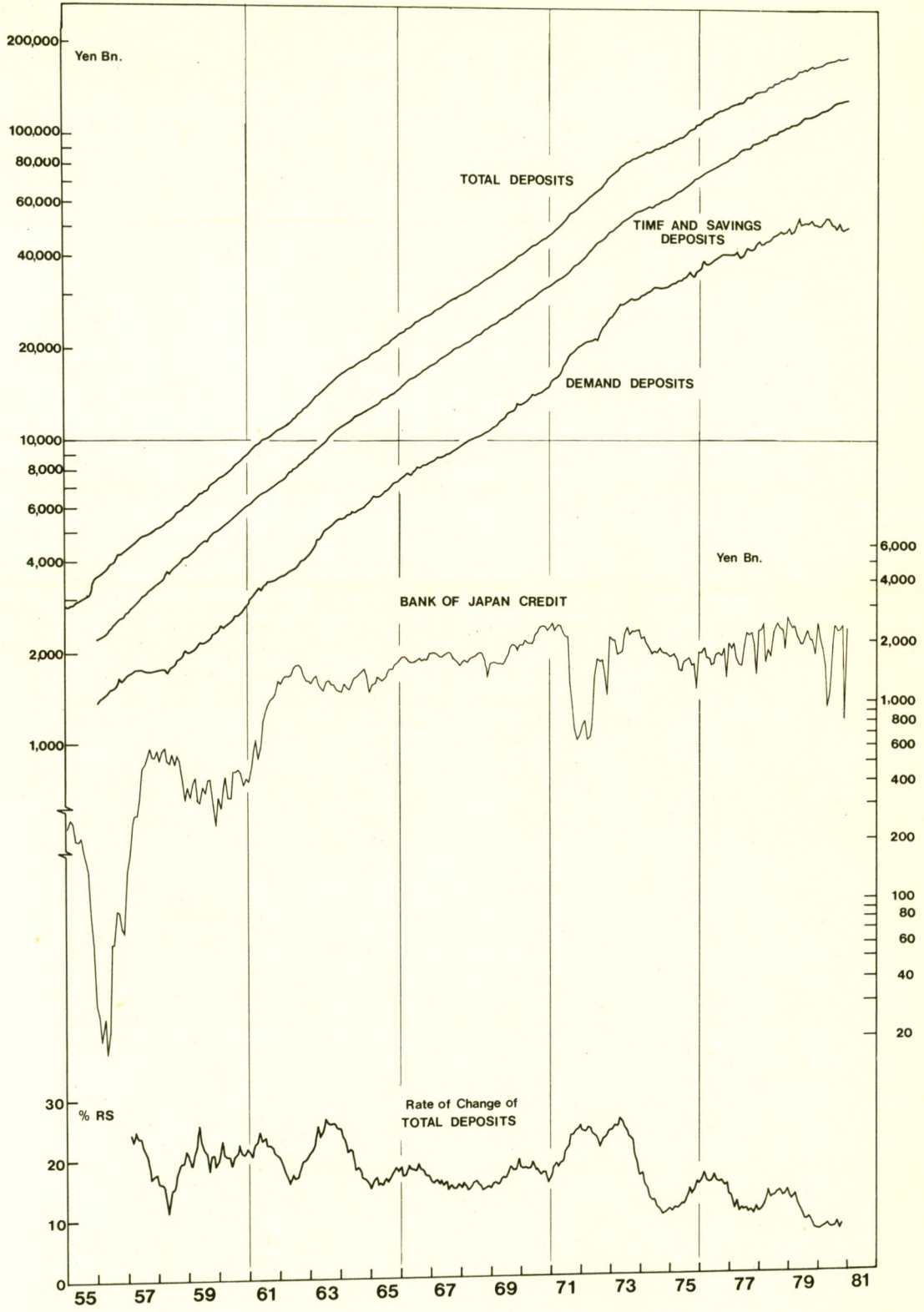
CHART 5 : BANK ASSETS



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JAPAN

CHART 6 : BANK LIABILITIES



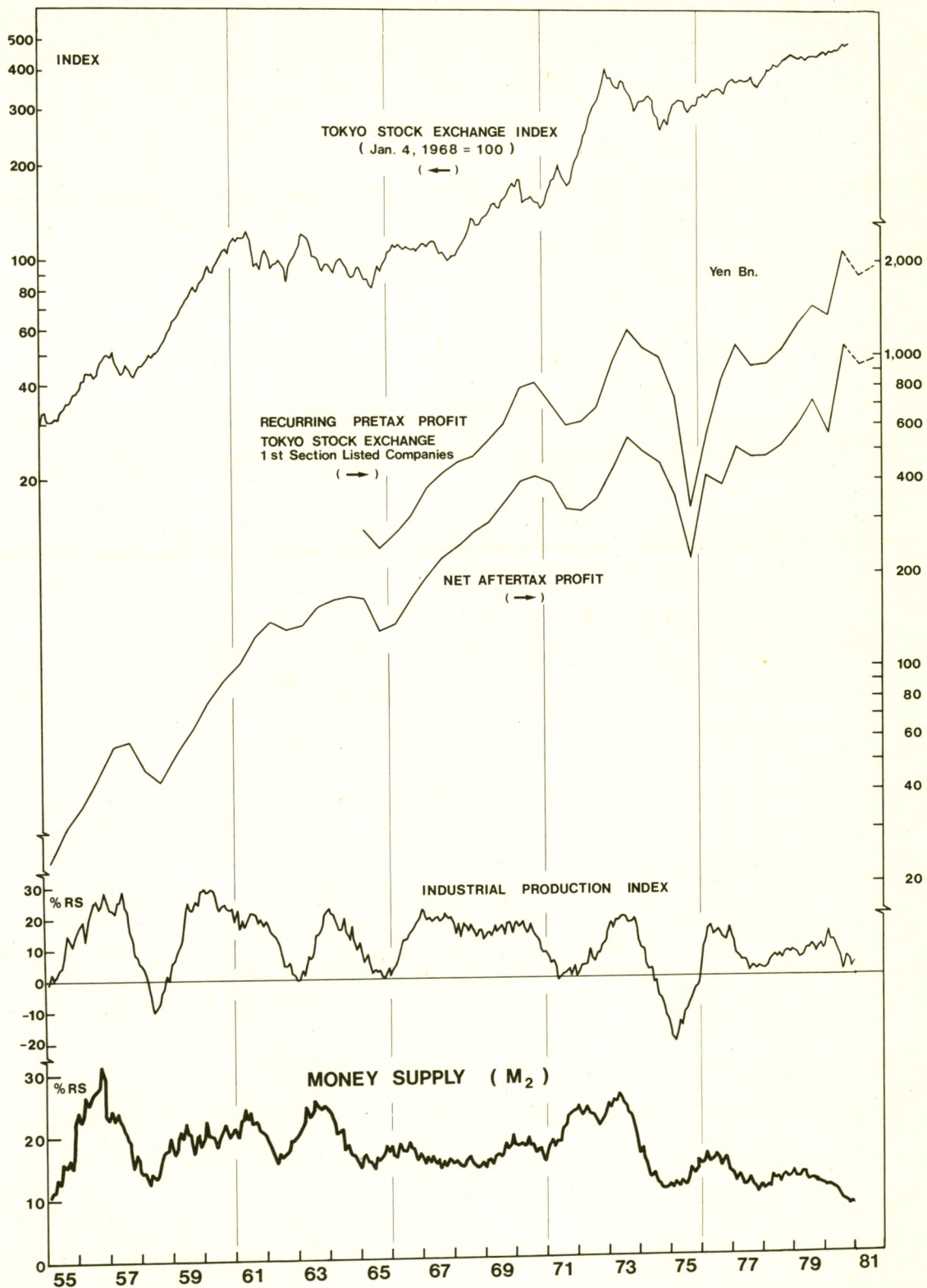
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Second, freer competition in the market for funds has put pressure on bank margins. Many banks probably did not foresee the steep rise in rates in 1979-80, but had already made a considerable quantity of term loans (up to two years). They were then hit by rising money market rates and falling bond prices. In addition, because banks (along with trading companies) had become extremely unpopular with the public at large during the period of high inflation in 1973-75 due to the low rates paid on deposits it was more difficult for the bureaucracy to mobilise the public support necessary to obtain the political agreement for banks to raise their rates so quickly this time. Although rates in the money markets bottomed out in November 1978, deposit interest rates at City Banks were not raised until May 1979. (They were raised again in August 1979, but the next increase was not effected until March 1980.) Added to all these woes increased competition for deposits by the Post Office has reduced City Banks' share of total deposits.

FORECAST: Initial steps towards interest liberalisation have resulted in deregulation of some specific markets, more flexibility in most money market rates, and wider participation in the money markets generally. Although deregulation has led to some shifting of funds between financial institutions which has caused the M_2 measure of money supply to undershoot Bank of Japan targets, the increased flexibility of rates generally and the wider percolation of the effects of changes in interest rates have on the whole assisted in the implementation of Japan's successful monetary policy. The greater flexibility of rates and the diversification of fund sources will continue to put competitive pressure on the banks, and - as in the aftermath of any programme of deregulation - one should expect to see structural changes in the industry such as changes in market shares mergers, and possibly even some smaller banks going to the wall. Provided the Bank of Japan continues to focus on controlling the monetary aggregates in the interest of overall economic stability through carefully regulating the growth of the monetary base, the intensification of competitive pressures in the Japanese banking industry will ultimately benefit all bank customers - depositors and borrowers - even if for a time bank shareholders go through a difficult period.

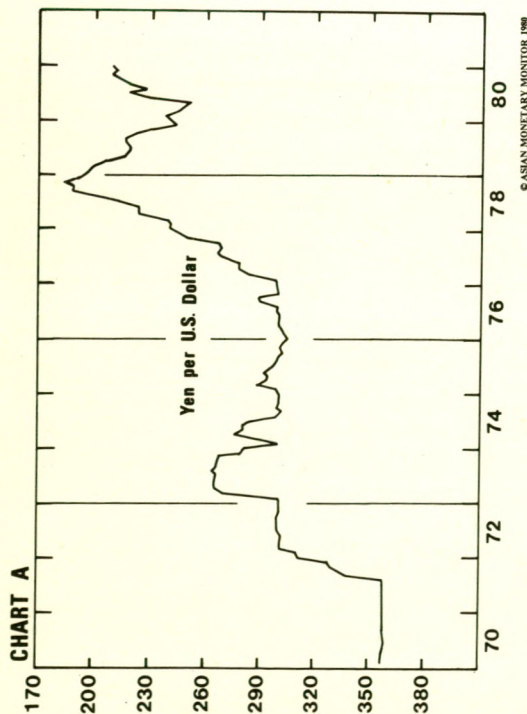
JAPAN

CHART 7 : MONEY, OUTPUT, PROFITS AND STOCK PRICES



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JAPANESE YEN



The yen continues to show cyclical strength against the US dollar and other major currencies. The transition from the cyclical weakness that lasted from the fourth quarter of 1978 to March 1980 coincided with the steep decline in US interest rates which occurred in April and May of this year. (Compare Charts A and C.) Nevertheless this should not be interpreted as an implication that the yen is a particularly interest rate sensitive currency. The yen's underlying trend has remained firm since March in spite of two reductions in the Bank of Japan's Official Discount rate (from 9% to 7½%) and a massive rise in US short rates in the second half of the year. It is true that the rapid changes in the interest rate differential have led to quite sharp movements in the yen/dollar rate, but such adjustments, as may be seen in Chart A, have been of an essentially speculative, temporary nature.

The principal determinant of the current cyclical strength in the yen lies in Bank of Japan's coherent and successful anti-inflationary policy, and the impact this has had on Japanese trade incentives. In the wake of large commodity price increases during 1979 when the Japanese economy continued to grow strongly, the yen weakened as Japan's current account swung sharply to deficit (compare Charts A and B). However throughout this period the Bank of

Japan engineered a steady reduction in monetary growth, as may be seen in Chart E. This low growth in the money supply enabled Japan to maintain a moderate increase in consumer prices in spite of severe cost push pressures as a result of the weaker yen and higher import prices.

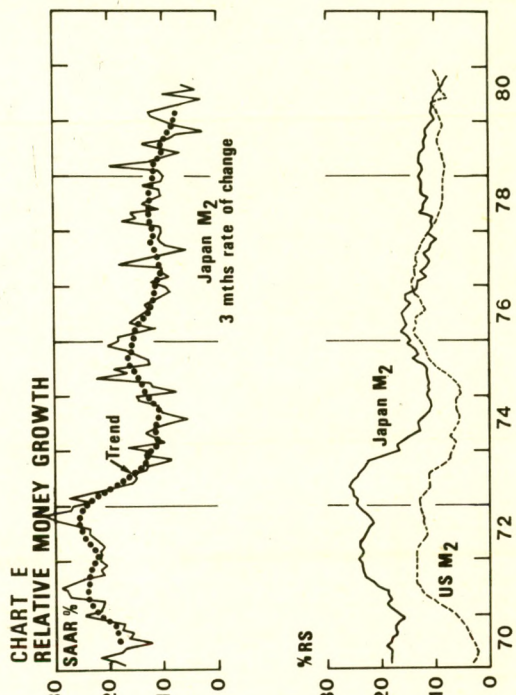
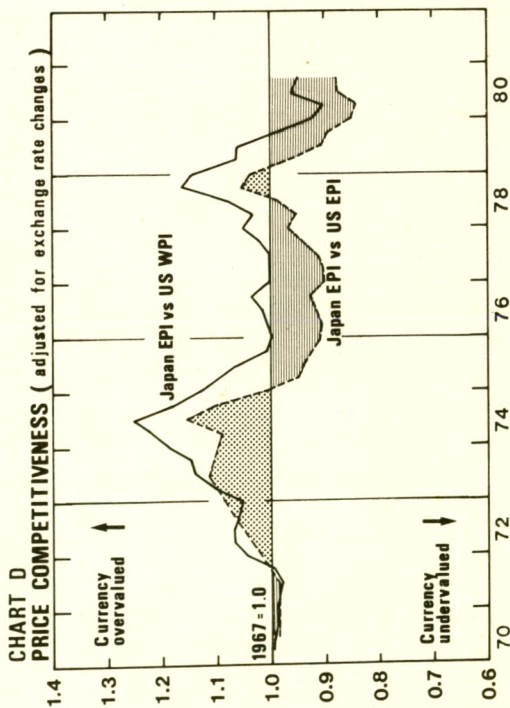
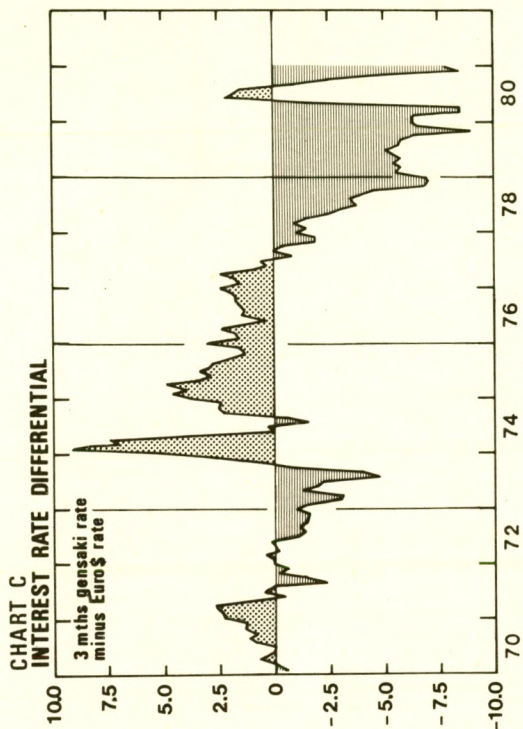
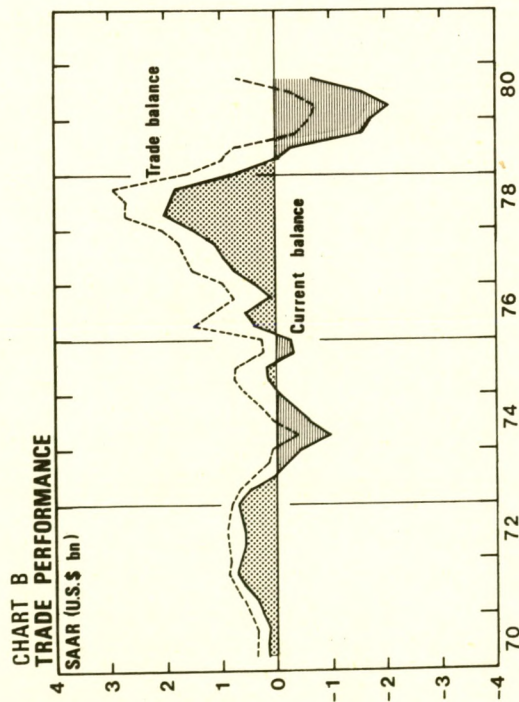
As a consequence of these trends the yen became fundamentally oversold (see Chart D). However the slowdown in the economy which followed the decline in liquidity, coupled with the weak yen reduced Japan's overall import demand. At the same time the weaker currency and low level of domestic inflation increased Japan's export competitiveness. The combination of these two influences resulted in a dramatic turnaround in the Japanese trade position. This has provided the foundation for the yen's cyclical strength. Moreover, the yen's appreciation has more or less eliminated the cost push pressures on domestic inflation; the wholesale price index has been virtually unchanged since April. For the time being, the yen appears to be enjoying a classic "virtuous circle", and so long as the trend in the trade account remains favourable we expect further upward pressure on the yen. In this regard we anticipate that a real economic growth rate somewhat below trend for the next quarter will continue to temper Japanese import demand. In our view this will more than compensate for a slightly lower increase in export receipts arising from slower growth in many of Japan's major markets.

The most important risk to our forecast lies in the possibility of another substantial rise in oil prices or, more crucially, the interruption of OPEC supplies. A rise in US rates would probably postpone further appreciation in the yen, but we doubt they would damage its favourable trend.

Yen/US\$	Actual			Forecast	
	1980	Q2	Q3	Q4	1981 Q1
FORECAST A					
Actual Range	215.55-260.7	211.6-228.0		210-220	205-220
FORECAST B				195-210	190-208

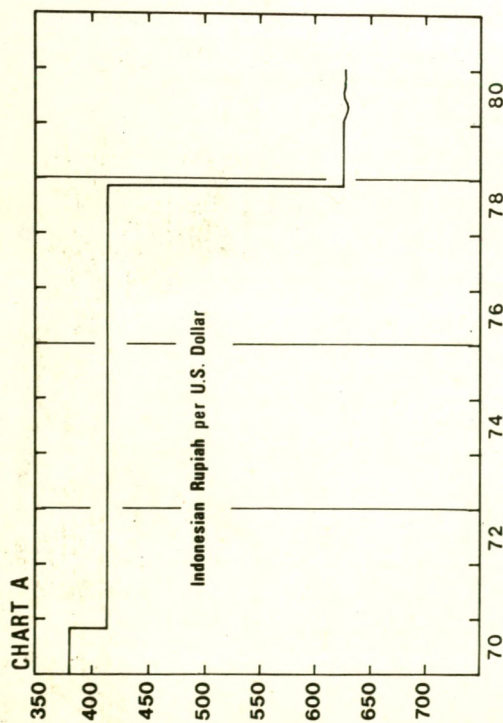
Forecast A assumes that Japan's trade position continues to improve over the medium term but that prime rates in the US continue rising well into the first quarter of 1981.

Forecast B assumes that Japan's trade position will continue improving in the medium term but that prime rates in the US peak out towards the end of the last quarter of 1980.



EPI : EXPORT PRICE INDEX
SAAR : SEASONALLY ADJUSTED AT ANNUAL RATE
RS : RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

INDONESIAN RUPIAH



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The characteristics of Indonesia's business cycle since the first oil crisis are markedly different from otherwise similar economies in S.E. Asia. Throughout the period 1973-78 the trend in monetary growth was declining whereas in many other fixed exchange economies, like the Philippines, the sharp contraction in 1974-5 was followed by surge in liquidity commencing in 1976. Nevertheless, although the decline in money growth successfully reduced Indonesian inflation from above 40% in 1973-4 to less than 10% in late 1978, it was not sufficient to bring price levels more or less into line with those in the US. As a consequence the Indonesian Rupiah (then Rp. 415=US\$1) appears to have become increasingly overvalued from 1973 to the fourth quarter of 1978. (See Chart D.) Moreover, because of the decline in liquidity during this period Indonesia suffered a mediocre growth performance at a time when countries such as the Philippines were booming. With inflation at historically moderate levels by late 1978, the Indonesian authorities evidently decided that it would be too painful, in terms of Indonesia's growth prospects, to continue with the monetary squeeze. They devalued the currency by 33% to Rp. 625=US\$1 in November 1978.

A comparison of Charts D and E suggests that even this very substantial devaluation is likely to prove inadequate in the longer term. Chart D indicates that at current levels of inflation the

Rupiah is some 40% overvalued on a fundamental basis. Moreover monetary growth has accelerated quite sharply since the devaluation and inflation has climbed back to around 20%. With the US keeping a reasonably tight rein on its money supply it seems likely that the Rupiah will remain overvalued, thereby raising the possibility of a further devaluation.

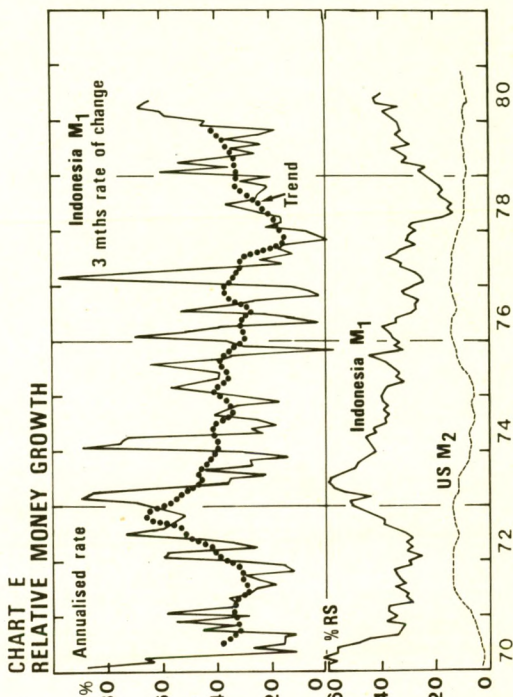
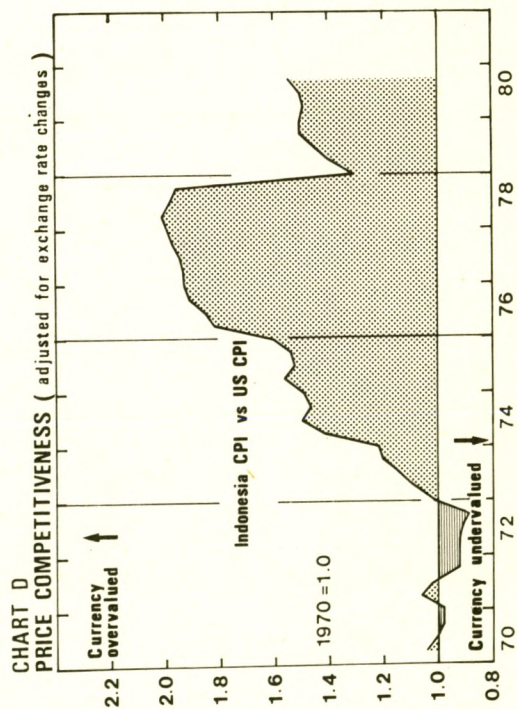
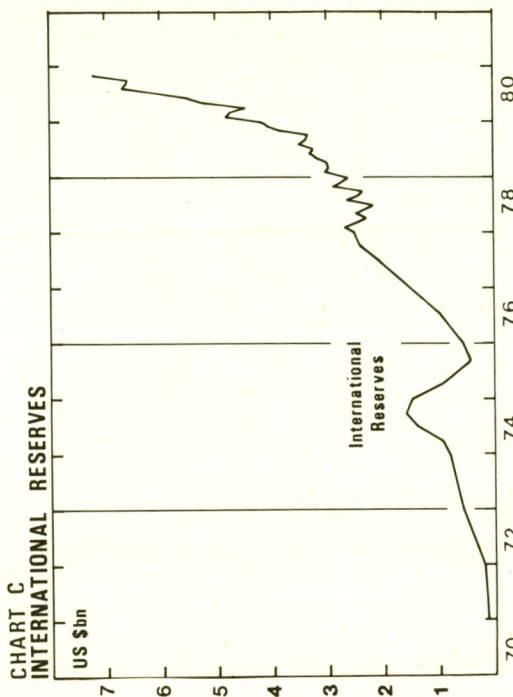
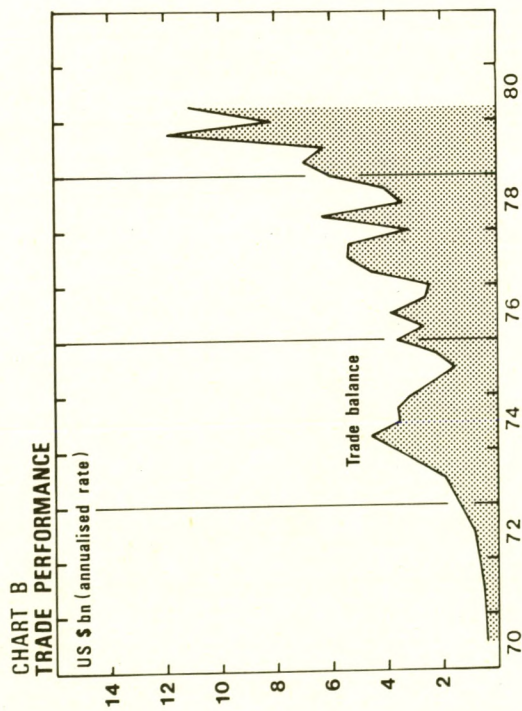
It must be acknowledged that the validity of comparing relative inflation rates as a strict guide to the long run equilibrium exchange rate is suspect in the case of countries like the US and Indonesia which are at very different stages of development. This is especially the case given the large differences in the quality and coverage of the price indices used. The predicted exchange rate shown in Chart D is therefore fairly tentative. No great significance should be attached to any level at any one moment in time. However, the general direction of the predicted rate is probably a helpful indication of the longer term strength or weakness of the Rupiah.

In spite of the unfavourable long term trend we do not anticipate any weakness in the Rupiah against the dollar during the short term. Indonesia is the world's tenth largest oil exporter, and crude petroleum and petroleum products form some 65% of Indonesia's total exports. The doubling of the posted oil price since April 1979 has led to a substantial improvement in the Indonesian trade surplus, and the authorities are confidently predicting a record balance of payments surplus for 1981. Although the Rupiah looks to be overvalued, the favourable external position suggests there will be no immediate downward pressure on the exchange rate. Even if such pressure were to emerge during the course of the next business cycle the Indonesian authorities could probably use the accumulated reserve position to defend the current rate for a considerable period of time.

Rupiah/US\$	Actual			Forecast	
	1980	Q2	Q3	Q4	1981 Q1
FORECAST A					
Actual Range	625.25-628.5	625.75-626.5		875*	885*
FORECAST B					
				626.5-628.5	626.5-628.5

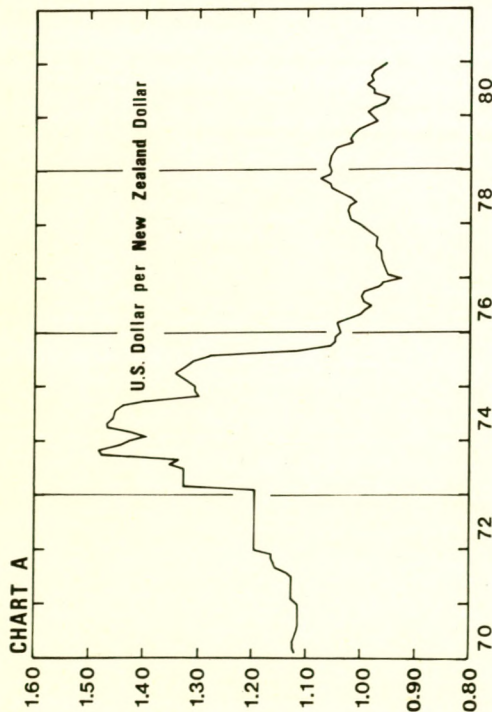
Forecast A* is based on a tentative projection of relative price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line.

Forecast B is the most likely range in the absence of some major political or external disruption.



RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

NEW ZEALAND DOLLAR



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The New Zealand dollar is effectively pegged to the US dollar. Despite substantial and rapid changes in inflation and interest rate differentials over the last eighteen months the NZ\$/US\$ rate has moved in a narrow range from 1.0113 to 0.9760.

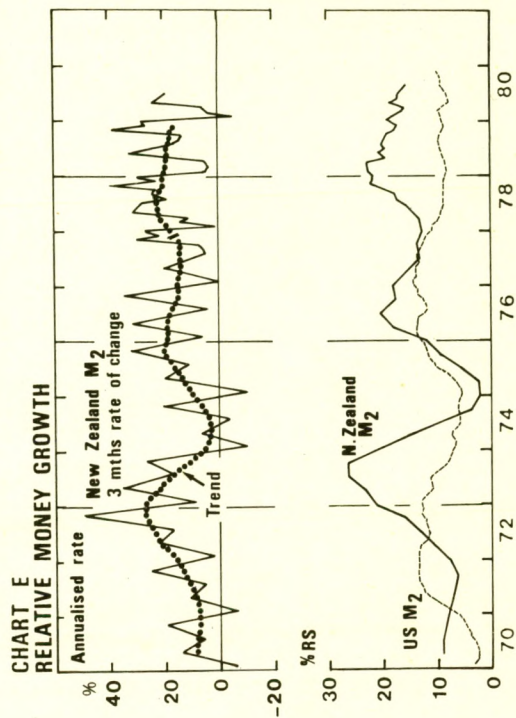
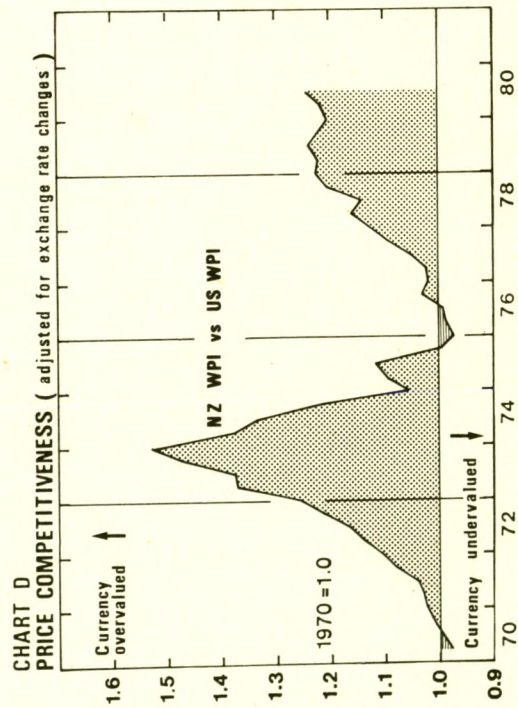
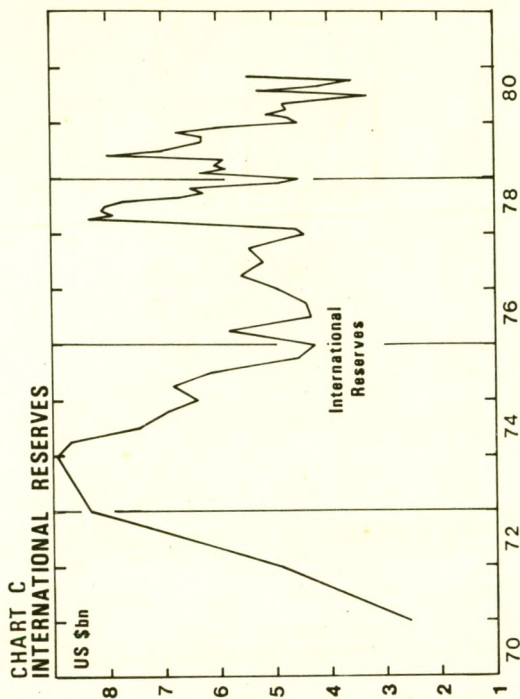
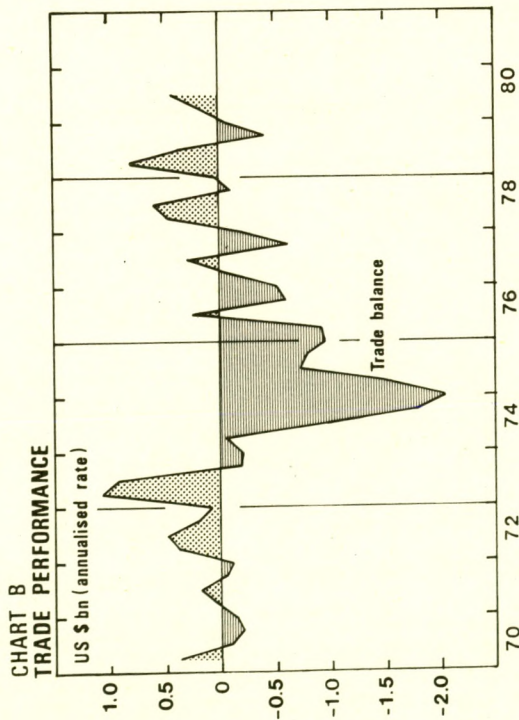
Rough parity between the New Zealand and US dollar appears difficult to justify on fundamental grounds. Since the period of tight liquidity during 1974 and 1975 (which was precipitated by a dramatic deterioration in the external account as shown in Chart B) the New Zealand monetary authorities have pursued a relatively easy monetary policy. Since the end of 1975 the average yearly rise in M_3 in New Zealand has been just slightly less than 17%, or significantly above that in the US (see Chart E). This disparity in monetary growth rates has led to a gradual widening of the New Zealand - US inflation rate differential. Consumer prices in New Zealand rose sharply in 1979 from a low of approximately 10% during the first quarter to 16.5% in December. Although inflation now appears to be levelling off at close to 17%, it remains substantially in excess of the current rate in the US. The widening of the inflation rate differential against the New Zealand dollar has led to the New Zealand currency becoming progressively overvalued on a comparison of relative price levels, as illustrated in Chart D.

Over the last eighteen months, the New Zealand monetary authorities have had some success in dampening monetary expansion. The growth in M_3 has declined from a year-on-year rate of 22% in February 1979 to 16% by the third quarter of 1980. The decision to tighten may have been prompted by the large decline in New Zealand's official reserves, which are presently at their lowest level since 1972 (see Chart C). The raising of the official discount rate to 14% in July suggests that the authorities intend to continue with a tighter monetary policy. We anticipate a weaker trade position during 1981 which will assist the government in this respect. Nevertheless, although such measures are necessary in order to establish stronger fundamental backing for the New Zealand dollar, they are typically only effective after a lag. With inflation remaining high, and the trade position showing a tendency towards weakness, we expect the New Zealand dollar to remain relatively weak against both the Australian and US dollars.

NZ\$/US\$	Actual			Forecast	
	1980	Q2	Q3	Q4	1981 Q1
FORECAST A					
Actual Range		0.9668-0.9837	0.9760-0.9817	0.82	0.80
FORECAST B				0.9600-0.9750	0.9575-0.970

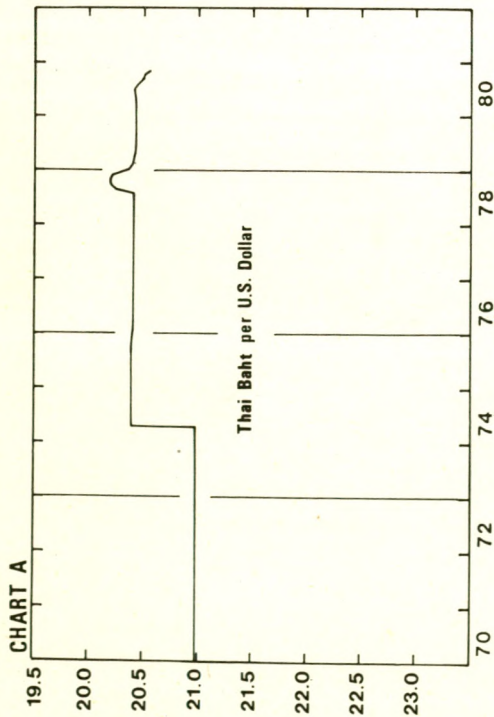
Forecast A is based on a simple projection of relative price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line.

Forecast B is the most likely range in the absence of some major political or external disruption.



RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR

THAI BAHT



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Unlike in previous business cycles the Thai authorities have opted not to allow their economy to follow the economic slowdown in the US. After declining throughout 1979, the trend in monetary growth has been reversed during 1980 (Chart E). Therefore in contrast to previous periods when the US economy has been reasonably weak, liquidity in Thailand has remained relatively buoyant.

This has had two fundamental consequences. First, easy liquidity has sustained high rates of consumer and wholesale price inflation. Although the rise in Bangkok consumer prices has moderated from a year-on-year peak of 24.2% in May to less than 17% in October we should be cautious in extrapolating this into the future. The steep rise in the reported inflation rate from 9.6% in the second quarter of 1979 reflects, in part, the government's decision to abolish price controls on a wide range of basic commodities in the summer of 1979. Nevertheless, the expansionary monetary policy pursued during 1980 has accommodated the subsequent price rises. With monetary growth at current levels it is unlikely that there will be a strong cyclical decline in inflation as occurred during 1975.

The second result of the easy liquidity conditions in Thailand this year is that economic activity has remained relatively firm. With high inflation, this has been reflected in a further

deterioration in Thailand's trade balance (see Chart B). Export growth has declined whilst imports continue to increase by around 35% per annum. Typically a large rise in the trade deficit would lead to deterioration in the overall balance of payments position. This in turn would bring about an external drain on monetary growth. This is broadly what occurred during the last business cycle.

(Compare Charts B and E.) However the Thai authorities have attempted to circumvent the drain on domestic liquidity caused by a rising trade deficit by increasing official overseas borrowing. Long term official foreign debt has more than doubled since July 1979. As a result the overall balance of payments is not creating severe downward pressure on the Thai baht.

However, in addition to mitigating any pressure on the exchange rate, Thailand's overseas borrowing programme is also preventing the cyclical decline in monetary growth and inflation which, under a fixed exchange rate regime, would otherwise follow an external deficit. Inflation is therefore likely to remain high relative to that in the US, and the Thai authorities will be forced to continue borrowing from overseas since there is little prospect of a sustained recovery in the trade account. At present, Thailand still enjoys a good credit rating on international capital markets, and her reserve position remains relatively healthy (see Chart C). It is therefore likely that Thailand will continue to be able to fund its trade deficit in order to avert a devaluation of the baht in the short term. Nevertheless, in view of the relatively high levels of monetary growth, inflation and the record trade deficit we anticipate further small depreciations against the US dollar.

Baht/US\$	Actual			Forecast	
	1980	Q2	Q3	Q4	1981 Q1
FORECAST A					
Actual Range	20.410-20.425		20.451-20.497	23.5	23.5
FORECAST B				20.50-20.55	20.55-20.60

Forecast A is based on a simple projection of relative price competitiveness shown in Chart D i.e. the exchange rate required to bring US and local price levels into line.

Forecast B is the most likely range in the absence of some major political or external disruption.

CHART B
TRADE PERFORMANCE

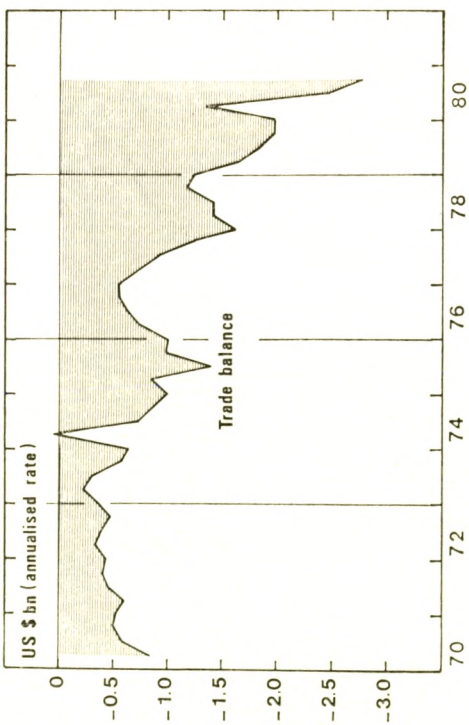


CHART C
INTERNATIONAL RESERVES

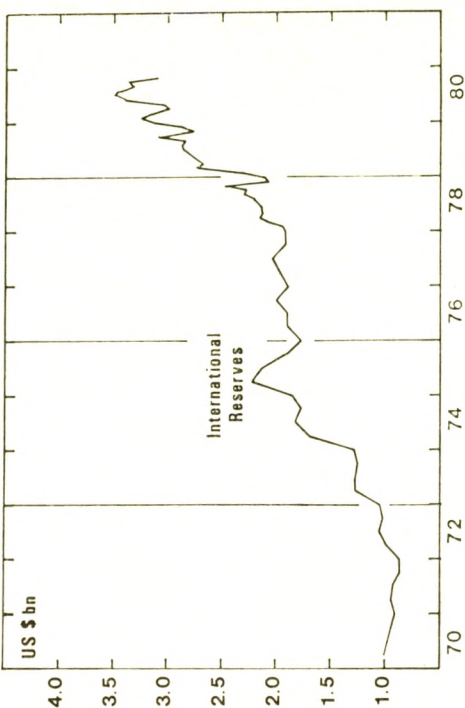


CHART D

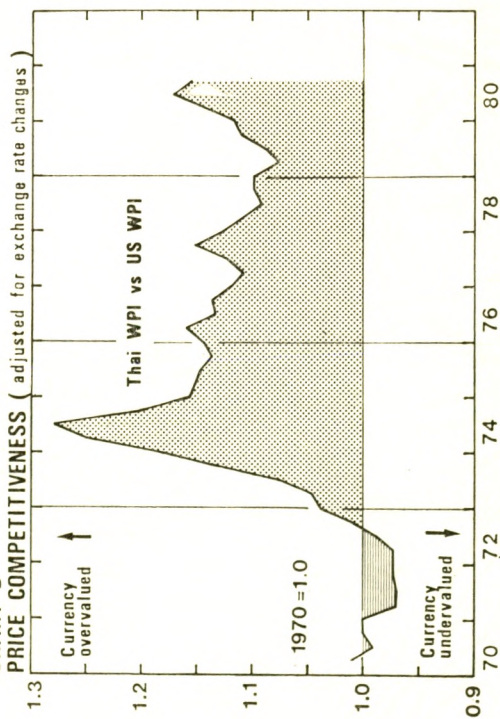
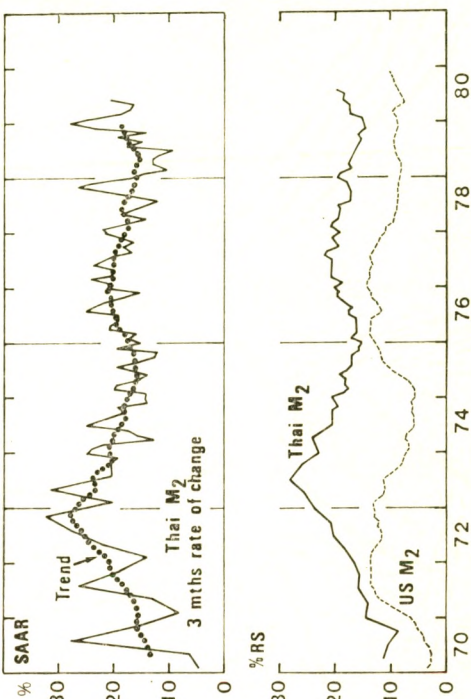


CHART E
RELATIVE MONEY GROWTH



SAAR: SEASONALLY ADJUSTED AT ANNUAL RATE
RS: RATE OF CHANGE OVER SAME MONTH OF PREVIOUS YEAR



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